

March 04, 2008



Nancy M. Morris
Secretary, U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-0609

Dear Ms. Morris,

We appreciate the opportunity to comment on the Commission's proposal for a summary mutual fund prospectus (File No. S7-28-07, Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies).

We support the Commission's effort to make mutual fund disclosure more understandable and meaningful, but am concerned that the proposed summary prospectus fails to appreciate the difficulties that fund investors have in understanding and processing fund information. Our research of the financial literature indicates that most investors are unaware of even the basics of their funds, do not take costs (especially ongoing costs) into account when they invest, are unable to appreciate fund risks, and chase past fund performance, despite scant evidence that past returns predict future returns. Fund investors who use financial advisers do no better.

In short, until the Commission faces the cognitive biases and investment limitations that most fund investors face, further streamlining of fund disclosures is unlikely to help. At the heart of the problem is that fund investors believe that past returns are predictive. By and large, they are not. A disclosure regime that continues to highlight past returns as a predictor of future returns (with disclaimers that only intensify the false belief there is a strong correlation between the two) disserves investors.

As retail investors move from choosing stocks and bonds to selecting between mutual funds, and in the absence of mechanisms for informational efficiencies in mutual fund selection, the Commission cannot rely only on disclosure reforms. And as our national retirement system moves to mutual funds as the primary investment vehicle, it is not enough to say that the investing public must learn to fend for itself.

You'll notice that none of the commenters to the proposed summary prospectus offers a clear portrait of who mutual fund investors really are. They make guesses and assumptions – as does the rule proposal itself. The attached manuscript (which is to appear soon on SSRN) seeks to offer a portrait based on an extensive body of finance literature.

Sincerely yours,

/S/

Alan Palmiter
Professor of Law
Ahmed Taha
Associate Professor of Law

Attachment ("Mutual Fund Investors: Divergent Profiles")



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Mutual Fund Investors: Divergent Profiles
[DRAFT]

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MUTUAL FUND INVESTORS: DIVERGENT PROFILES

Alan R. Palmiter & Ahmed E. Taha¹

Mutual funds are owned by almost half of all U.S. households, manage over \$12 trillion dollars in assets, and have become a primary vehicle for investment and retirement savings. Who are mutual fund investors? The answer is critical to regulatory policy. Fund investors, by selecting the funds in which they invest, play a central role in determining asset allocation and in controlling the fees funds charge. Thus, the functioning of the mutual fund market turns on the knowledge and financial sophistication of fund investors.

This article examines the profiles of mutual fund investors presented by the mutual fund industry, by the SEC, and by an extensive empirical academic literature produced primarily by finance professors. The industry portrays fund investors as diligent, fairly sophisticated, and guided by professional financial advisers. The industry claims that the result is a competitive mutual fund market as fund investors demand low costs and solid performance. The SEC's regulatory policy paints a more cautious portrait of fund investors. While acknowledging that many investors have limitations, the SEC touts improved disclosure by the industry as a sufficient antidote. The academic literature, however, finds that fund investors are generally ignorant and financially unsophisticated. Most investors are unaware of even the basics of their funds, do not take costs (especially ongoing costs) into account when they invest, and chase past fund performance, despite little evidence that past returns predict future returns. Fund investors who use financial advisers do no better.

The SEC's belief that fund investors can fend for themselves, once armed with adequate disclosure, fails to appreciate the extent of investors' limitations. Instead, the findings of the academic literature suggest that policymakers should rethink the current regulatory approach. Disclosure may not be enough.

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INTRODUCTION

Mutual funds have become a primary vehicle for investment and retirement savings in the United States, managing over \$12 *trillion* in assets and more than one-quarter of the country's retirement savings. Almost half of all U.S. households own mutual funds, far more than own individual stocks and bonds. Unlike public and private pension plans, in which decisions about portfolio allocation and cost management are delegated to professional money managers, the mutual fund industry is subject to the decisions and discipline of millions of dispersed and diverse mutual fund investors.

Who are these mutual fund investors? Their investment knowledge and acumen, as well as their access to and use of information about mutual funds, are critical to the effective functioning of the mutual fund market. Unlike the markets for publicly-traded securities, such as stocks, the market for mutual funds lacks mechanisms to ensure informational efficiency. A handful of informed, sophisticated fund investors cannot price inefficiencies (such as high-cost, mismanaged or poorly-constructed funds) out of the market.

The Investment Company Act of 1940, passed by Congress to regulate the disclosure and management of mutual funds, assumes that mutual fund investors cannot adequately fend for themselves. Nonetheless, despite doubts about the capabilities of fund investors, the 1940 Act also assumes (somewhat inconsistently) that fund investors can make basic asset-allocation and fund-selection decisions. The 1940 Act thus adopts a blurred policy between regulatory paternalism and market liberalism, with a significant portion of market discipline left not to regulation, but to fund investors themselves.

Today the importance of an effective mutual fund market is greater than ever, and its importance promises only to grow. The transformation of mutual funds from the "small investor's diversified portfolio" to "every person's retirement account" makes the functioning and capabilities of fund investors critical to the viability of our national retirement system. Do fund investors understand the risk-return characteristics of different fund assets? Do fund investors know the relationship between past fund performance and future returns? Do fund investors recognize the significance and respond to differences in fund cost structures? In short, are fund investors capable of disciplining the mutual fund market?

This article examines the profiles of mutual fund investors presented alternatively by the mutual fund industry, by the Securities and Exchange Commission ("SEC"), and by an extensive academic literature. The fund management industry – through its trade association, the Investment Company Institute ("ICI") – portrays fund investors as diligent and fairly

sophisticated. According to the ICI, before choosing a mutual fund, investors consider relevant fund characteristics, including fund fees and expenses, and consult multiple sources of information. In comments to the SEC and in other public statements, the ICI regularly states that mutual funds operate in a highly competitive market driven by millions of investors clamoring for low fees and high performance. To assist investors in choosing a fund, the industry supports providing investors with simplified and standardized disclosure of information about funds.

The SEC, in its regulatory policy, paints a somewhat similar portrait of mutual fund investors. Like the fund industry, the SEC suggests that investors consider much relevant information before investing in a fund. Also, like the industry, the SEC believes that investors greatly benefit from (and use) simplified and standardized disclosure. Yet the SEC has expressed concern that some investors pay too little attention to fund fees and expenses, while paying too much attention to past returns. Thus, the SEC has taken some limited and cautious steps to better educate and inform fund investors about how to make better choices.

The academic literature over the last decade, however, paints a much less favorable portrait of fund investors. Empirical studies of actual investor behavior – studies conducted mostly by finance professors – find that fund investors generally are unknowledgeable, lack financial sophistication, and suffer from numerous cognitive biases. These studies find that most fund investors are unaware of the investment objectives, composition, and risks of their funds. Most investors are also ignorant of the level of fees and expenses charged by their funds, and these costs are not a significant factor in their fund choices. Also, most fund investors chase past performance, despite significant evidence that past returns generally do not predict future returns. In addition, although many investors use financial advisers, little evidence exists that these advisers help investors make better choices.

Remarkably, the ICI and the SEC barely acknowledge the existence of this large and consistent body of academic research. Although the ICI has sometimes sought to refute some specific academic findings, it appears to have adopted the general policy that the less said the better. The SEC, while regularly citing to journalistic accounts of the behavior of fund investors, has also disregarded the academic literature. Instead, SEC rulemaking releases routinely cite to *ICI* research and comment letters, particularly with respect to the information needs of fund investors.

In short, there is overwhelming evidence of investors' limitations and of their inability to protect their own interests, a key premise of the 1940 Act regulatory regime. This evidence, however, is disregarded by the industry that purports to serve fund investors and by the regulator charged with responding to market failure. Although the industry trumpets the

“highly competitive market” in which it operates and the SEC extols the virtues of competition, the evidence overwhelmingly suggests that fund investors lack the knowledge and financial sophistication to discipline the mutual fund industry.

This article questions the accuracy of the portraits of mutual fund investors painted by the fund industry and the SEC, and seeks to offer a more accurate (if less attractive) portrait painted by the academic literature. It argues that policymakers should pay greater attention to fund investors’ ignorance and limitations, which undermine the viability of our private retirement system. Recent efforts by the SEC to educate investors and to improve mutual fund disclosure fail to recognize the extent of investors’ limitations. Thus, these efforts are unlikely to significantly improve investors’ ability to pursue their own interests and, in doing so, to provide important market discipline over mutual funds.

Section I provides background information about mutual funds, the companies that create and manage them, and the investors who buy them. Section II presents the profile of the mutual fund investor as advanced by the ICI. Section III identifies the fund investor profile adopted by the SEC. Section IV describes the academic literature on fund investor knowledge and behavior, which presents an investor profile far different from those advanced by the ICI and SEC. Finally, Section V discusses the implications that the academic literature has for the SEC’s regulatory policy toward mutual funds.

I. THE MUTUAL FUND MARKET

A mutual fund pools multiple investors’ money into a single investment portfolio created and managed by a fund management company.² Investors who purchase shares of the fund, typically organized as a separate corporation or trust, are entitled to the proportionate return from the assets held by the fund. Thus, the investors do not own the fund assets directly, but rather own pieces of the mutual fund. Investors have the right to withdraw their investment at any time at a price determined by the fund’s net asset value. There is considerable variation among mutual funds, including the types of financial assets held, the investment objectives and strategies, and the fee structures – all as set forth in the fund’s prospectus. The SEC is the primary regulator of the mutual fund

² For a description of the basic characteristics of mutual funds, see Securities and Exchange Commission, *Invest Wisely: An Introduction to Mutual Funds*, <http://sec.gov/investor/pubs/inwsmf.htm> (last visited Feb. 15, 2008) [hereinafter SEC, *Invest Wisely*].

industry, but no government agency guarantees or insures investors' fund investments.

As of December 2007, U.S. mutual funds held just over \$12 trillion in assets, representing more than one-quarter of the total value of the U.S. equity and bond markets.³ Investors have a great number of funds to choose from – 8,726 as of the end of 2006.⁴ Some fund families such as Fidelity Investments and the Vanguard Group, offer hundreds of funds.⁵ Although no single fund family dominates the mutual fund market, the five largest fund families control 36% of the industry's total assets.⁶

Ownership of mutual funds is widespread. Of the 116 million households in the United States, almost 51 million (or 44%) own mutual funds, far more than hold individual stocks and bonds.⁷ Also, most households that hold mutual funds have moderate income and wealth. The median household income of mutual fund investors is \$68,700.⁸ The large majority of households (67%) that own mutual funds have incomes of less than \$100,000, and 26% have incomes below \$50,000.⁹ In addition, the median fund-owning household has total financial assets of only \$125,000, and 47% of their total financial assets are invested in mutual funds.¹⁰

³ ICI Statistics & Research, Trends in Mutual Fund Investing (Dec. 2007), http://www.ici.org/stats/mf/arctrends/trends_12_07.html [hereinafter ICI, Investing Trends].

⁴ INVESTMENT COMPANY INSTITUTE, 2007 INVESTMENT COMPANY FACT BOOK 10 (2007), available at <http://www.icifactbook.org>. [hereinafter 2007 FACT BOOK].

⁵ For example, Vanguard has over 150 funds and Fidelity has over 200 funds. Sensible Investing Made Easy, <https://personal.vanguard.com/us/FundsStocksOverview?Entry=Homeoffer01> (last visited Feb. 15, 2008); Fidelity Daily Prices & Funds Distributions, http://personal.fidelity.com/products/funds/content/FidelityMutualFunds/fund_distribution_s.shtml.cvsr?refpr=mfrt4 (last visited Feb. 15, 2008) (listing current Fidelity funds).

⁶ 2007 FACT BOOK, *supra* note 4, at 10, 17.

⁷ INVESTMENT COMPANY INSTITUTE, ICI RESEARCH FUNDAMENTALS: TRENDS IN OWNERSHIP OF MUTUAL FUNDS IN THE UNITED STATES 2, fig. 1 (Nov. 2007), <http://www.ici.org/stats/res/fm-v16n5.pdf> [hereinafter ICI, OWNERSHIP TRENDS].

⁸ Investment Company Institute, Frequently Asked Questions About Mutual Fund Shareholders, http://www.ici.org/new/faqs_mf_shareholders.html. (last visited Feb 8, 2008) [hereinafter ICI, Questions]

⁹ ICI, OWNERSHIP TRENDS, *supra* note 7, at 5 fig.6.

¹⁰ ICI, Questions, *supra* note 8.

Mutual fund ownership has become widespread largely because mutual funds have become a primary way that Americans save for retirement. Employers have increasingly switched from providing traditional pension plans – defined-benefit plans – to providing defined-contribution retirement plans, such as 401(k) plans. In defined-contribution plans, employers make contributions to their employees’ retirement accounts, but the employees themselves choose how to invest these contributions. Typically, mutual funds are among the investment options available to the employees.

As of June 2007, U.S. retirement assets totaled \$17.4 trillion,¹¹ constituting 39% of all household financial assets.¹² About \$4.4 trillion (25%) of retirement assets were in defined-contribution plans, and more than half of the assets in these plans (\$2.3 trillion) were invested in mutual funds.¹³ In contrast, in 1992, only \$184 billion of assets in defined-contribution plans were invested in mutual funds.¹⁴ In other words, defined-contribution plans’ assets invested in mutual funds has grown more than 18% annually over the past fifteen years.

Mutual fund assets in Individual Retirement Accounts (“IRAs”) have experienced similar growth. As of June 2007, IRAs constituted an estimated \$4.6 trillion, or 26%, of all retirement assets.¹⁵ Nearly half (47%) of IRA assets (\$2.2 trillion) were invested in mutual funds.¹⁶ By comparison, in 1992, only \$233 billion of IRA assets were invested in mutual funds. Thus, mutual fund assets invested in IRAs has grown more than 16% annually over the last fifteen years.¹⁷

¹¹ Investment Company Institute, Research Fundamentals: The U.S. Retirement Market, Second Quarter 2007, at fig.1 (Dec. 2007), http://www.ici.org/pdf/retmrkt_update.pdf [hereinafter, ICI, Retirement Market].

¹² *Id.* at fig.2.

¹³ *Id.* at fig.7.

¹⁴ *Id.* at fig.A2.

¹⁵ *Id.* at fig.1.

¹⁶ *Id.* at fig.A2.

¹⁷ *Id.* at fig.A2. A significant portion of IRAs originate in employer-sponsored retirement plans that are "rolled over" into IRAs when the employee leaves an employer. For example, in 2004 – the latest year for which data is available – traditional IRA’s received approximately \$214 billion in rollovers but only \$12 billion in other contributions. *Id.* at fig.A5.

Primarily as a result of the rapid growth of mutual fund investments in defined-contribution plans and IRAs, mutual funds' total share of retirement assets increased from 8% in 1992 to 26% in June 2007.¹⁸ Mutual funds now constitute more than a quarter of Americans' total retirement savings, and the proportion is growing.

Although the greatest portion of mutual fund assets (46%) are held in tax-deferred retirement accounts, such as IRAs and defined-contribution plans, most mutual fund assets are held elsewhere.¹⁹ Those mutual fund assets are in taxable accounts held by households (36%), taxable accounts held by non-households (11%) and tax-exempt funds (7%).²⁰ Investors, however, undoubtedly consider some of these other mutual fund assets as retirement savings too. Limits on the amount investors can contribute annually to these tax-deferred accounts means that some retirement savings are invested outside of tax-deferred accounts.²¹

The majority of mutual fund holdings are in equities (60%), with the remainder divided between money market assets (26%) and bonds (14%).²² Equities tend to have higher returns in the long run, but greater

¹⁸ *Id.* at fig.A3. In addition to being in defined contribution plans and IRA's, retirement assets are in annuities, government pension plans, and private defined benefit plans (i.e. traditional private pension plans). *Id.* at fig.1.

¹⁹ 2007 FACT BOOK, *supra* note 4, at 18 & fig.2.4.

²⁰ *Id.*

²¹ For example, in 2007, most people were permitted to contribute no more than \$15,500 each year to defined contribution plans and \$5,000 to an IRA. INTERNAL REVENUE SERVICE, PUBLICATION 525: TAXABLE AND NONTAXABLE INCOME 8 (2007), available at <http://www.irs.gov/pub/irs-pdf/p525.pdf>; INTERNAL REVENUE SERVICE, PUBLICATION 590: INDIVIDUAL RETIREMENT ACCOUNTS 11, 59 (2007), available at <http://www.irs.gov/pub/irs-pdf/p590.pdf>.

²² As of December 2007, total net assets of mutual funds were:

	<u>\$ Billions</u>	<u>% of Total</u>
Stock Funds	6,528.0	54.2
Hybrid Funds	714.3	5.9
Taxable Bond Funds	1,305.5	10.8
Municipal Bond Funds	373.9	3.1
Taxable Money Market Funds	2,650.0	22.0
<u>Tax-Free Money Market Funds</u>	<u>467.6</u>	<u>3.9</u>
Total	12,039.4	100%

ICI, Investing Trends, *supra* note 3.

risk in the short run, than bonds and money market securities.²³ Lifecycle funds, a relatively new segment of private retirement savings, allow fund investors to delegate asset allocation decisions to the fund manager. Lifecycle funds blend particular asset types (such as stocks and bonds) to match investors' risk tolerance and investment horizon, shifting their asset mix over time in light of investors' retirement target date. Although growing by 61% in 2006 to \$114 billion (after also rising 61% in 2005), the funds still constitute less than one percent of retirement assets.²⁴

In summary, our nation relies upon mutual funds. Ownership of mutual funds has become widespread, with about half of American households owning mutual funds. These funds constitute a significant portion of our savings and are a particularly important component of our retirement system. As a result, appreciating fund investors' characteristics – especially their knowledge, financial sophistication, and how they choose among mutual funds – is essential to understanding and safeguarding this system.

This article presents three profiles of the mutual fund investor: one put forward by the mutual fund industry, another assumed by the SEC, and yet another identified by the academic finance literature.

II. INDUSTRY'S PORTRAIT OF FUND INVESTORS: SOPHISTICATED AND INFORMED

The first portrait of the mutual fund investor is painted by the fund industry itself. Established in 1940, the Investment Company Institute ("ICI") is the national trade association of the U.S. mutual fund industry. As of August 2007, ICI members served 90 million individual investors and were responsible for 8,729 mutual funds that collectively held \$11.5 trillion in assets.²⁵ The ICI's stated mission includes "advancing the interests of funds, their shareholders, directors, and investment advisers. . . ."²⁶ To accomplish its mission, the ICI often provides input

²³ JEREMY J. SIEGEL, *STOCKS FOR THE LONG RUN* 12-18, 24-27 (4th ed. 2008).

²⁴ Investment Company Institute, *THE U.S. RETIREMENT MARKET, 2006* at 10-11 (July 2007), <http://www.ici.org/pdf/fm-v16n3.pdf>.

²⁵ INVESTMENT COMPANY INSTITUTE, *2007 ANNUAL REPORT* ii (2007), available at http://www.ici.org/statements/ppr/07_ici_annual.pdf. ICI members also were responsible for 656 closed-end funds, 546 exchange-traded funds, and 5,907 unit investment trusts. *Id.*

²⁶ Investment Company Institute, *About ICI*, http://www.ici.org/about_ici.html (last visited Feb 15, 2008).

regarding the regulation of mutual funds to Congress, the SEC, and other regulatory organizations.²⁷

The ICI has consistently maintained that the mutual fund industry is highly competitive, with fund choices, services and fees determined by a robust market of sophisticated and informed mutual fund investors. Relying on the results of a 2006 ICI-sponsored survey of investors who had purchased mutual funds outside of retirement plans, the ICI has asserted that fund investors seek out and examine important fund information before investing, including the fund's investment objectives, fees and expenses, historical performance, and risk. The ICI survey concluded that investors obtain information about mutual funds from a variety of sources, and most receive guidance from professional financial advisers. In short, the survey portrays mutual fund investors as generally knowledgeable and well-advised, leaving little need for greater regulation of the industry.

In other settings, the ICI has presented a slightly more cautious portrait of mutual fund investors. In its publications, speeches by its officials, and comments to the SEC, the ICI has regularly supported simplifying and standardizing required disclosure by mutual funds. Implicit in these statements is some recognition of the limitations and lack of sophistication of many mutual fund investors.

This section presents the profile of mutual fund investors as advanced by the ICI. It is noteworthy that, in developing this portrait, the ICI relies almost exclusively on its own studies, without reference to academic studies of fund investor knowledge and behavior.

A. ICI Survey of (Some) Fund Investors

In 2006, the ICI “undertook a comprehensive study ... to identify the information needs of mutual fund investors and the sources from which they obtain that information.”²⁸ The study consisted of in-home interviews of 737 randomly-selected mutual fund investors who had bought – outside of a work-related retirement plan – a stock, bond, or

²⁷ Much of this input is accessible on the ICI's website. Investment Company Institute, Testimony, <http://www.ici.org/statements/tmny/index.html> (last visited Feb 15, 2008); Investment Company Institute, Comment Letters, <http://www.ici.org/statements/cmltr/index.html> (last visited Feb 15, 2008).

²⁸ INVESTMENT COMPANY INSTITUTE, UNDERSTANDING INVESTOR PREFERENCES FOR MUTUAL FUND INFORMATION 1 (Aug. 2006), http://ici.org/pdf/rpt_06_inv_prefs_full.pdf (last visited Feb. 17, 2008) [hereinafter ICI, INVESTOR PREFERENCES].

hybrid fund that they didn't own prior to 2001.²⁹ The study excluded mutual fund investors who purchased only money market funds, who had only added to an already-owned fund, and who had purchased funds only through a 401(k) or similar work-related plan.

Survey findings. A “key finding” of the survey, according to the ICI, is that investors “consider a wide range of information before purchasing mutual fund shares. They most frequently review or ask questions about a fund’s fees and expenses and its historical performance.”³⁰ Indeed, 74% of those surveyed stated that they review a fund’s fees and expenses before investing.³¹ The second most reviewed information is the fund’s “historical performance,” which 69% of surveyed investors stated they review, and the third is the “fund risks,” which 61% of those surveyed said they review.³²

A second “key finding” of the ICI survey was that “[s]hareholders consult a variety of sources for mutual fund information before and after purchasing shares, and one of these sources is usually a professional financial adviser. Shareholders primarily turn to advisers for assistance in understanding and interpreting fund information.”³³ Investors reported consulting an average of three sources before buying a fund.³⁴ Financial advisers are, by far, investors’ most consulted source of information with 73% of those surveyed reporting that they consulted a “professional financial adviser” before buying a mutual fund.³⁵ The next most consulted sources are “fund company or other websites” (46%) and “friends, family, or business associates” (40%).³⁶

Summary and analysis. The ICI survey paints a very favorable portrait of mutual fund investors. According to the survey, before choosing a mutual fund, investors obtain essential fund information, such

²⁹ *Id.* at 1 & n.2. The survey was conducted by GfK NOP, an independent research firm. *Id.* at 1.

³⁰ *Id.* at 1.

³¹ *Id.* at 3 fig.1.

³² *Id.*

³³ *Id.* at 1.

³⁴ *Id.* at 4 Fig.2.

³⁵ *Id.*

³⁶ *Id.*

as costs, returns, and risks, and they usually are assisted by professional financial advisers. If this profile is accurate, it suggests that investors have the acumen and knowledge to provide market discipline over mutual funds.

The ICI survey, however, may be of limited value. It only surveyed investors who own funds outside of employer-sponsored plans, thus missing a large and growing number of fund investors who own funds inside such plans. Moreover, most of the surveyed investors reported using financial advisers, a resource often unavailable with employer-sponsored plans. The survey, which was conducted through face-to-face interviews, also relied upon the surveyed investors to accurately self-report their own behavior. Respondents predictably may have given what they saw as the right answer, not necessarily the truthful one. For example, an investor who admits buying a fund without examining its fees and expenses (the price for investing in the fund) is admitting buying a service without considering the price. It is well known that survey respondents often lie to avoid embarrassing themselves.³⁷

B. ICI Statements Regarding Fund Investors

The ICI has also profiled mutual fund investors, explicitly and implicitly, in other publications and in statements by its officials. In addition, as the national trade association for the mutual fund industry, the ICI regularly sends comment letters to the SEC regarding proposed mutual fund rules.³⁸ The comment letters often state or reflect the ICI's view of mutual fund investors. As a whole, these publications, statements, and comment letters present a portrait of mutual fund investors who place great emphasis on fund fees and expenses when choosing among mutual funds, thus creating a competitive fund market that disciplines the industry. In addition, the ICI has portrayed investors as having available to them –

³⁷ See, e.g., Carl Bialik, *When It Comes to Donations, Polls Don't Tell The Whole Story*, WALL ST. J. ONLINE, <http://online.wsj.com/public/article/SB110806528683351584.html?mod=blogs> (discussing examples of when survey respondents have lied and quoting Jeffrey M. Jones, managing editor of the Gallup Poll, as explaining that "[t]he [survey] interview is a social experience. . . . As would be the case in a cocktail party or at a job interview, you want to give a good impression of yourself.").

³⁸ Before the SEC adopts new regulations of mutual funds, it seeks the input of the public. The SEC publishes the proposed regulation in the Federal Register and asks the public to comment on the proposals. The SEC typically responds to any comments in the Federal Register and sometimes even modifies or retracts the proposals in light of the comments.

and using – a great deal of information about funds when making their fund choices.

Investors are sensitive to fund costs. The ICI frequently asserts that investors search for funds with low fees and expenses. For example, Paul Stevens, the President and CEO of the ICI, recently stated that “investors tend to seek out lower-cost funds.”³⁹

As evidence of investors’ preference for low fund fees and expenses, the ICI has pointed out that investors are heavily invested in lower-cost funds. In its study of competition in the mutual fund industry, the ICI concluded that “more than three-quarters of stock and bond fund assets are invested in funds charging below-average operational and management expenses. . . .”⁴⁰ In addition, a 2005 ICI study described a 25-year trend of declining fund fees and expenses. The ICI study found that investors paid on average 113 basis points⁴¹ to invest in stock funds, 90 basis points for bond funds, and 41 basis points for money market funds – the lowest cost levels for each class of fund in more than 25 years.⁴²

The ICI regularly claims that cost-sensitive investors impose a strong market discipline on mutual funds. For example, in a recent publication on competition in the mutual fund industry, the ICI stated that “[t]he 90 million fund shareholders’ demand for investment performance and services at a competitive level of fees and expenses continuously impacts mutual funds.”⁴³ Similarly, the ICI noted that “[i]ncreased investor demand for low-cost funds accounted for more than half of the decline in the asset-weighted average expense ratio [in 2005].”⁴⁴

³⁹ Paul Schott Stevens, ICI Welcomes Efforts to Improve 401(k) Disclosure (March 7, 2007), http://www.ici.org/statements/nr/2007/07_news_401k_hrg.html#TopOfPage. (last visited Feb 16, 2008)

⁴⁰ INVESTMENT COMPANY INSTITUTE, RESEARCH COMMENTARY: COMPETITION IN THE MUTUAL FUND BUSINESS 1 (January 2006), available at http://www.ici.org/stats/res/rc_competition.pdf [hereinafter ICI, COMPETITION].

⁴¹ A basis point is 0.01% of the fund’s assets. Thus paying 113 basis points on a \$10,000 investment costs an investor \$113 annually.

⁴² INVESTMENT COMPANY INSTITUTE, FEES AND EXPENSES OF MUTUAL FUNDS, 2005 at 2 fig.1 (Jun. 2006), available at <http://www.ici.org/statements/fundamentals/fm-v15n4.pdf> [hereinafter ICI, FEES & EXPENSES].

⁴³ ICI, COMPETITION, *supra* note 40, at 1.

⁴⁴ ICI, FEES & EXPENSES, *supra* note 42, at 1. *See also*, INVESTMENT COMPANY INSTITUTE, A GUIDE TO UNDERSTANDING MUTUAL FUNDS, at 23 (2007),

ICI officials echo this view. For example, John Murphy, the General Membership Meeting Chairman of the ICI, recently stated that “the free market still reigns as the most powerful source of accountability. Market competition offers a strict, comprehensive, and daily form of discipline. The score on funds is printed in the paper and on the Internet every day. Mutual fund managers know that unhappy investors are never more than a phone call or mouse click away from switching to another provider.”⁴⁵

While trumpeting investor demand for lower-cost funds, however, the ICI has been careful not to strongly encourage investors to seek such funds. For example, an online mutual fund primer sponsored by the ICI Education Foundation and the National Urban League is silent about the effect of expenses, fees, and loads on fund returns.⁴⁶ Instead, fund investors are urged to focus on “time in the market” rather than “timing the market.”⁴⁷ The primer points out that (since 1926) annual stock market returns have averaged 11% since 1926, but doesn’t indicate how much less mutual fund investors have received because of the drag of fund fees and expenses.⁴⁸

Investors access great amounts of fund information. ICI officials have also credited as a source of market discipline the great amount of information about funds available to investors.⁴⁹ They claim that this

http://www.ici.org/pdf/bro_understanding_mfs_p.pdf (“Mutual funds compete vigorously to keep costs low, since the performance figures reported by the fund, and the total value of [an investor’s] mutual fund account, are provided after all fees and expenses have been deducted.”).

⁴⁵ John V. Murphy, Gen. Membership Meeting Chairman, Welcoming Remarks at the Investment Company Institute’s 2006 General Membership Meeting (May 17, 2006), (transcript available at http://www.ici.org/statements/remarks/06_gmm_murphy_spch.html#TopOfPage).

⁴⁶ Investment Company Institute Educ. Found. and Nat’l Urb. League, Investing for Success, <http://www.icief.org/introduction/index.html> (last visited Feb. 16, 2008). In the 230 pages of the online primer, the terms “fees” and expenses do not appear except with respect to college costs, and the terms “12b-1” and “loads” are not mentioned at all.

⁴⁷ Investment Company Institute Educ. Found. and Nat’l Urb. League, Investing for Success, http://www.icief.org/realistic/index.html?real_lesson3.html~text (last visited Feb. 16, 2008).

⁴⁸ Inv. Co. Inst. Educ. Found. and Nat’l Urb. League, Investing for Success, http://www.icief.org/realistic/index.html?real_ill2.html~text (last visited Feb. 16, 2008).

⁴⁹ See, e.g., Paul Schott Stevens, President, Inv. Co. Inst., Address at the Investment Company Institute Gen. Membership Meeting (May 17, 2006), (transcript available at http://www.ici.org/issues/tax/arc-leg/06_gmm_stevens_spch.html) (“If mutual funds have succeeded, it is because they rest on strong regulatory and market disciplines - the high

information allows investors to compare funds, forcing funds to compete for investors.⁵⁰

Interestingly, however, the ICI has also asserted that most investors may be receiving too much information about funds. Thus, the ICI has supported steps taken by the SEC to reduce, summarize, and standardize the information in the fund prospectus⁵¹ and to create even more basic disclosure documents, such as the fund profile.⁵² In addition, the ICI has supported SEC initiatives to simplify the language used in disclosure documents so that investors can better understand them.⁵³

The ICI supports such disclosure reforms because it believes that investors are more likely to read and understand simplified and

standard of fiduciary duty the law justly demands of fund managers, the abundant information funds must supply to their investors, the fiercely competitive environment in which funds operate, and the resulting scrutiny to which they are subject.”).

⁵⁰ Murphy, *supra* note 45 (“[m]utual funds are arguably the most scrutinized, regulated, and transparent products in financial history. Our industry features a large number of firms, all competing for investors' loyalty. Barriers to entry are low and information to compare competing products is widely available.”).

⁵¹ See, e.g., Letter from Paul Stevens, Senior Vice President & Gen. Counsel, Inv. Co. Inst., to Jonathan Katz, Sec’y, Sec. & Exch. Comm’n (June 9, 1997), available at http://www.ici.org/statements/cmltr/97_sec_formn1a_com.html [hereinafter Stevens-Katz Letter] (supporting the SEC’s proposal to require the prospectus to contain a standardized risk/return summary because the ICI “believe[s] the summary will assist investors both in understanding the key features of a particular fund and in comparing different funds.”). In addition, the ICI has supported changes to the prospectus “to minimize potential investor confusion and to avoid unnecessary clutter.” *Id.*

⁵² *Id.*; Letter from Paul Schott Stevens, Senior Vice President and Gen. Counsel, Inv. Co. Inst., to Barry P. Barbash, Dir., Div. of Inv. Mgmt., Sec. & Exch. Comm’n (May 20, 1996), available at http://www.ici.org/statements/cmltr/96_sec_profile_prosp_com2.html [hereinafter Stevens-Barbash Letter] (stating that ICI and mutual fund complexes’ research found that “substantially more shareholders are likely to actually *read* the profile prospectus than the traditional prospectus because the profile provides the information they need more succinctly, in a way they can more readily understand, and in a format they can more easily use.”).

⁵³ For example, the ICI supported the SEC’s requiring that the risk/return summary be written in “plain English.” *Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Fund Costs and Distribution Practices: Before the S. Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. (March 31, 2004) (statement of Paul G. Haaga, Jr., Chairman, Inv. Co. Inst.), available at http://www.ici.org/stateents/tmny/04_sen_haaga_tmny.html. In addition, the ICI recommended that the SEC require that, in drafting a fund profile, “mutual funds, to the extent possible, use language that a typical investor would understand and avoid the use of technical terms and the relegation of critical information to footnotes.” Stevens-Barbash Letter, *supra* note 52.

standardized information.⁵⁴ In fact, the ICI has called for even simpler disclosure than has been adopted by the SEC so far.⁵⁵ Paul Stevens, the ICI's President, recently suggested that investors receive "something like a quick-start guide [similar to what is provided with some electronic equipment] when they buy fund shares."⁵⁶ This guide would be a "clear, concise document that highlights the key information that a fund buyer wants and needs, in an easy-to-understand form."⁵⁷

The ICI, however, has sometimes opposed disclosure reforms on the grounds that investors can obtain the information from other sources. For example, the ICI supported the NASD's decision to require disclosure of annual expense ratios in performance advertisements,⁵⁸ but not the actual dollar amount of expenses that would be incurred by a hypothetical fund investor. The ICI argued that "fund advertisements are not intended to be the exclusive source for investors of information about the fund, which is why all advertisements under Rule 482 are required to encourage potential investors to read the fund's prospectus carefully before investing and include information about how an investor may obtain the prospectus."⁵⁹

Less has also been more when it comes to cautioning investors. The ICI has assumed that investors will be able to read cautionary disclosures placed in television ads, thus making oral disclosure unnecessary. Thus, in letters to both the SEC and the Municipal Securities Rulemaking Board,

⁵⁴ Stevens-Katz Letter, *supra* note 51 ("by adopting the profile, the Commission would address the clear need for a fund disclosure document that many more of today's 63 million fund shareholders actually will read and use in making investment decisions.").

⁵⁵ Paul Schott Stevens, President, Inv. Co. Inst., Remarks at The National Press Club: Revolution in Real Time: Using the Internet to Inform Investors Better (Feb. 14, 2006) (transcript available at http://www.ici.org/statements/remarks/07_mfim_stevens_spch.html) ("There is widespread agreement that today's disclosure system is not optimal from the fund investor's perspective. Most investors seek information that is clear and concise. They value quality, not quantity.").

⁵⁶ Paul Schott Stevens, President, Inv. Co. Inst., Remarks at Mutual Funds and Investment Management Conference: When You Come to a Fork in the Road, Take It: Improving Financial Regulation in America (Mar. 26, 2007) (transcript available at http://www.ici.org/statements/remarks/07_mfim_stevens_spch.html).

⁵⁷ *Id.*

⁵⁸ A performance advertisement is a mutual fund advertisement that presents a fund's historical returns.

⁵⁹ Letter from Dorothy M. Donohue, Assoc. Counsel, Inv. Co. Inst., to Barbara Z. Sweeney, Office of Corp. Sec'y, Nat'l Assoc. Sec. Dealers (Jan. 23, 2004), available at http://www.ici.org/statements/cmltr/04_nasd_ad_disclose_com.html#TopOfPage (footnote omitted).

the ICI pushed for disclosures required in television ads to be permitted to appear in text on the screen rather than being spoken.⁶⁰

Summary and analysis. Although sometimes inconsistent, the ICI's profile of fund investors should be comforting to regulators. On their own, or with the assistance of financial advisers, fund investors impose market discipline on the mutual fund industry.⁶¹ According to the ICI, mutual fund investors diligently seek out and digest important information about fund expenses, performance, and risks before investing. As a result, investors create pressure on funds to lower expenses and achieve high returns. At the same time, however, the ICI warns that investors generally will only read and understand disclosure that is concise and clear, and the ICI does not view loads, expenses and fees to be relevant to investor education.

III. SEC'S PORTRAIT OF FUND INVESTORS: CAPABLE (WITH SOME HELP)

The SEC, although more sanguine than the industry, also paints a portrait of fund investors that implies a well-functioning mutual fund market. The SEC shares the industry view that fund investors consider a variety of important information before investing. The SEC also agrees that fund investors can become confused while navigating the sea of information about mutual funds and thus can benefit from fund information in a concise, readable, and standardized form. Unlike the industry, however, the SEC has specific concerns about investor

⁶⁰ Letter from Amy B.R. Lancellotta, Senior Counsel, Inv. Co. Inst., to Jonathan G. Katz, Sec'y, Sec. & Exch. Comm'n (July 31, 2002), available at http://www.ici.org/statements/cmltr/02_sec_fund_advert_com.html#TopOfPage ("with respect to television advertisements, we recommend that the Commission clarify that such disclosures need not be provided orally and that, instead, they may be provided in written text on the television screen."); Letter from Dorothy M. Donohue, Assoc. Counsel, Inv. Co. Inst., to Ernesto A. Lanza, Senior Assoc. Gen. Counsel, Mun. Sec. Rulemaking Bd., (Sept. 22, 2006), available at http://www.ici.org/statements/cmltr/06_msrb_ads_com.html#TopOfPage ("We also strongly support permitting the required information to be provided in an abbreviated manner and permitting a portion of the disclosure to be provided on the screen (rather than spoken) for television advertisements.").

⁶¹ See also INVESTMENT COMPANY INSTITUTE, UNDERSTANDING SHAREHOLDERS' USE OF INFORMATION AND ADVISERS 3 (1997), available at http://www.ici.org/statements/res/arc-dis/rpt_undstnd_share.pdf.

sophistication, worrying that fund investors pay insufficient attention to fund fees and expenses, and too much attention to past returns. The agency's solution is generally more and better disclosure.

Capturing the SEC's view, then SEC Chairman Arthur Levitt testified before Congress that "[t]he Commission should not be the arbiter of the appropriate level of fund fees. Whether fund fees are too high or too low is a question that we believe must be answered by competition in the marketplace, not by government intervention."⁶² That is, despite the underlying premise of the 1940 Act that fund investors cannot fend for themselves, the agency has assumed that demand-side market forces (properly informed) are sufficient to discipline any supply-side excesses.

This section describes the profile of fund investors presented by the SEC. This profile can be distilled from a number of sources, especially the disclosure the SEC requires in fund prospectuses, profiles, and advertising. In addition, recent attempts by the SEC to directly educate fund investors also reveal some awareness of investors' limitations. In general, it is a profile influenced significantly by industry comments and studies, and nearly oblivious to the findings of the academic literature on fund investor behavior.

A. SEC Regulation of Fund Disclosure

The SEC intends the fund prospectus to be the primary source of information for investors choosing a fund.⁶³ By law, a prospective fund investor must be provided with a fund's prospectus before or at the time that the investor purchases fund shares.⁶⁴ In addition, the SEC requires that fund advertisements explicitly direct investors to the prospectus.

⁶² *Transparency in the United States Debt Market and Mutual Fund Fees and Expenses: Hearings Before the H. Subcomm. on Finance and Hazardous Materials*, Comm. on Commerce, (Sep. 29, 1998) [hereinafter *Transparency Hearings*] (statement of Arthur Levitt, Chairman, Sec. & Exch. Comm'n), available at <http://www.sec.gov/news/testimony/testarchive/1998/tsty1398.htm>. See also U.S. GEN. ACCOUNTING OFFICE, MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION 7 (June 2000) [hereinafter GAO, MUTUAL FUND FEES] ("regulators rely on competition to be a primary means of influencing the fees that mutual fund advisers charge.").

⁶³ Registration Form Used by Open-End Management Investment Companies, 62 Fed. Reg. 10,898, 10,900 (proposed Mar. 10, 1997) (to be codified at 17 C.F.R. pt. 230, 239, 270, 274) ("The Commission regards the prospectus as an investor's primary source of information about a fund."); see also, SEC, Invest Wisely, *supra* note 2 ("The prospectus is the fund's selling document. . .").

⁶⁴ Securities Act of 1933 § 5(b)(2), 15 U.S.C. § 77e(b) (2) (2006).

Advertisements must explain that the prospectus contains information about the fund, must identify where investors can obtain the prospectus, and must warn “the prospectus should be read carefully before investing.”⁶⁵

The SEC recognizes that investors vary in sophistication and thus seek different types and amounts of information before buying a mutual fund.⁶⁶ However, the target audience for the prospectus, in the view of the SEC, is the typical investor.⁶⁷ Thus, the required content and form of the disclosures in the prospectus reflect the SEC’s view of the abilities and limitations of most mutual fund investors.

Investors benefit from streamlined disclosure. In its instructions regarding how to write a prospectus, the SEC asserts (although without elaboration or any empirical support) that most investors “may not be sophisticated in legal or financial matters.”⁶⁸ The SEC also recognizes that most investors are less likely to read a prospectus that is difficult to understand.⁶⁹ Thus, the SEC has tried to “streamline prospectus disclosure

⁶⁵ Amendments to Investment Company Advertising Rules, 68 Fed. Reg. 57,760, 57,777 (Oct. 6, 2003) (to be codified at 17 C.F.R. pt. 230, 239, 270, 274).

⁶⁶ Registration Form Used by Open-End Management Investment Companies, 62 Fed. Reg. at 10,900 (“Different investors prefer different amounts of information before making an investment decision, and regulatory requirements should not foreclose options that respond to prospective investors’ information needs.”); New Disclosure Option for Open-End Management Investment Companies, 63 Fed. Reg. 13,968, 13,970 (Mar. 23, 1998) (to be codified at 17 C.F.R. pt. 230, 270) (“[D]ifferent investors desire and use different types and amounts of materials in determining whether to invest in funds.”).

⁶⁷ Registration Form Used by Open-End Management Investment Companies, 62 Fed. Reg. at 10,900 (“The prospectus is intended to provide information about matters of fundamental importance to most investors.”); Registration Form Used by Open-End Management Investment Companies, 63 Fed. Reg. 13,916, 13,919 (Mar. 28, 1998) (to be codified at 17 C.F.R. pt. 230, 232, 239, 240, 270, 274) (“Funds should limit disclosure in prospectuses generally to information that is necessary for an average or typical investor to make an investment decision.”).

⁶⁸ SEC, Form N-1A, at General Instruction C(1)(b), available at <http://www.sec.gov/about/forms/formn1-a.pdf> (last visited Feb. 4, 2008).

⁶⁹ Registration Form Used by Open-End Management Investment Companies, 62 Fed. Reg. at 10,900 (“A prospectus . . . is not useful to investors if it is in a form that discourages investors from reading it.”). See also Registration Form Used by Open-End Management Investment Companies, 63 Fed. Reg. at 13,917 n.20 (amending certain prospectus disclosure requirements because the prior requirements “result in information that, while useful to some investors, is not necessary in the public interest or for the protection of investors to be included in the prospectus.”).

requirements to focus on essential information about a particular fund and make the prospectus less technical and easier to read.”⁷⁰

One way that the SEC has tried to make the prospectus more accessible to fund investors is by moving more complicated and detailed information out of the prospectus to another document. In 1983, the SEC adopted a “two-part disclosure format,” under which investors receive a “simplified prospectus designed to contain essential information” about a fund and, upon request, investors can also obtain a Statement of Additional Information that contains “more extensive information and detailed discussions of matters included in the prospectus.”⁷¹ In doing so, the SEC intended the prospectus to include only fund information that would be used by “typical or average investors” and the Statement of Additional Information to contain information of interest only to “sophisticated investors.”⁷²

Therefore, the contents of the prospectus reflect the SEC’s view of what information is useful to the “typical” mutual fund investor.⁷³ In the prospectus, the SEC requires information about:

- the fund’s investment objectives or goals⁷⁴
- the fund’s principal investment strategies⁷⁵
- the fund’s principal risks⁷⁶
- the fund’s returns over each of the last ten years⁷⁷
- the returns of an appropriate securities market index over the same periods⁷⁸

⁷⁰ Registration Form Used by Open-End Management Investment Companies, 62 Fed. Reg. at 10,900.

⁷¹ Registration Form Used by Open-End Management Investment Companies, 62 Fed. Reg. at 10,899.

⁷² Registration Form Used by Open-End Management Investment Companies, 63 Fed. Reg. at 13,917.

⁷³ Form N-1A, *supra* note 68, at General Instruction C(1)(b). (“The prospectus disclosure requirements . . . are intended to elicit information for an average or typical investor who may not be sophisticated in legal or financial matters.”).

⁷⁴ *Id.* at Items 2, 4.

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.* at Item 2.

⁷⁸ *Id.*

- the fund’s fees and expenses⁷⁹
- the fund’s managers, organization, and capital structure⁸⁰
- the fund’s policies regarding the pricing, purchase, and redemptions of fund shares, and regarding fund dividends and distributions (and their tax consequences)⁸¹
 - the fund’s distribution arrangements, including sales loads and 12b-1 fees⁸²
 - the fund’s “financial highlights” for each of the last five years, including the fund’s net asset value, income from investment operations, distributions, total return, net assets, expense ratio, ratio of net income to average net assets, and portfolio turnover rate.⁸³

Except for data on an “appropriate” market index, the prospectus need not provide any comparative information on performance, loads, fees, expenses or portfolio turnover. That is, fund investors must search elsewhere for how a particular fund compares to others. Nor does the prospectus have to suggest any sources for comparative information, such as Morningstar.⁸⁴ Instead, the SEC assumes fund investors, left to their own devices, can determine how a fund’s performance and costs compare to those of other funds.

Likewise, the prospectus need not educate investors about diversification, long-term returns of various asset classes (such as stocks or bonds), or the relationship of risks and returns. By excluding such information from the prospectus, the SEC is at least implicitly assuming that most investors already know or do not need this information.

The SEC’s rules regarding fund “profiles” offer additional insight into what the SEC perceives as the information needs of most investors. In

⁷⁹ *Id.* at Item 3. The prospectus defines “fees” as payments shareholders make directly from their investments (such as loads or exchange fees), and “expenses” as payments that are deducted from the fund’s assets (such as management fees and 12b-1 fees). *Id.*

⁸⁰ *Id.* at Item 5.

⁸¹ *Id.* at Item 6.

⁸² *Id.* at Item 7.

⁸³ *Id.* at Item 8.

⁸⁴ Morningstar, Inc. compiles detailed information about particular mutual funds and other securities. This data is accessible at <http://www.morningstar.com> (last visited Feb. 16, 2008).

1998, the SEC amended its rules to allow investors to buy mutual fund shares without having received a prospectus, as long as they received a fund profile beforehand.⁸⁵ The fund profile must summarize key fund information included in the fund prospectus and contain specific fund information on:

- objectives/goals
- principal investment strategies
- principal risks
- average annual returns [but without any comparison to a relevant market index];
- fees and expenses
- investment adviser, sub-adviser(s), and portfolio manager(s)⁸⁶
- investment requirements and front-end loads
- redemption procedures and back-end loads
- policies regarding fund distributions
- the tax consequences of fund distributions
- other services offered by the fund.⁸⁷

When the SEC's proposed the fund profile, it received several suggestions from third parties that additional information (including on portfolio holdings, investment style and risk measures) also be required in the profile.⁸⁸ While acknowledging the information might be "of interest to some fund investors," the SEC rejected its inclusion as "not necessarily essential information for the average or typical investor."⁸⁹

⁸⁵ An investor who bought the fund on the basis of the profile, however, is still be required to receive the prospectus with the confirmation of their purchase. New Disclosure Option for Open-End Management Investment Companies, 63 Fed. Reg. at 13,968.

⁸⁶ It must also contain information about the experience of the portfolio manager(s). 17 C.F.R. § 230.498(c)(2)(v)(C) (2008).

⁸⁷ 17 C.F.R. § 230.498(c) (2008).

⁸⁸ The suggested additional information included "a fund's top ten portfolio holdings; an investment style box; additional measures of risk; and financial highlights." New Disclosure Option for Open-End Management Investment Companies, 63 Fed. Reg. at 13,972.

⁸⁹ *Id.*

In its most recent effort to improve the disclosure that fund investors receive, the SEC proposed in November 2007 to “provide investors with streamlined disclosure of key mutual fund information at the front of the statutory prospectus, in a standardized order that facilitates comparisons across funds.”⁹⁰ The summary would be in plain English and 3-4 pages long. The SEC has proposed that the risk/return summary (described above) currently at the front of mutual fund prospectuses be the “centerpiece” of the new summary section. The new section, however, will also include some additional information so that the summary “will function as a more comprehensive presentation” than the current risk/return summary.⁹¹ The summary section would contain the following information about the fund, in a fixed order:⁹²

- investment objectives and goals
- costs (including a fee table and an example)
- principal investment strategies, risks, and performance (including the current risk/return bar chart and a table showing the fund’s past performance and the volatility of its returns)
- top ten portfolio holdings
- investment advisers and portfolio managers
- information regarding the purchase and sale of fund shares
- information about taxes resulting from fund distributions
- financial intermediary compensation⁹³

Importantly, some of the modifications to the current risk/return summary are aimed at “addressing concerns that investors do not understand that they pay ongoing costs every year when they invest in mutual funds.”⁹⁴ For example, in the current risk/return summary, the

⁹⁰ Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, 72 Fed. Reg. 67,790, 67,793 (proposed Nov. 30, 2007) (to be codified at 17 C.F.R. pt. 230, 232, 239, 274).

⁹¹ In addition, the SEC is proposing that, for a prospectuses that cover multiple funds, the summary information for each fund must be presented separately. This requirement is intended to facilitate investor understanding of the summary section in multi-fund prospectuses. *Id.*

⁹² *Id.* at 67,794.

⁹³ Investors are warned that if they purchased their fun shares through an intermediary and that intermediary receives compensation for the sale of the shares, that compensation may bias the intermediary’s advice to the investor. *Id.*

⁹⁴ *Id.* at 67,795.

heading “Annual Fund Operating Expenses” in the fee table is followed by the parenthetical “expenses that are deducted from Fund assets.” The new summary section would replace that parenthetical with the more understandable words “ongoing expenses that you pay each year as a percentage of the value of your investment.”⁹⁵

In addition, the SEC’s proposal would replace the fund profile (adopted in 1998) with a Summary Prospectus that contains the same information (in the same order) that would be in the new summary section of the full, statutory prospectus.⁹⁶ Investors would be permitted to buy a fund after having received just the Summary Prospectus, as long as the statutory prospectus is available online.⁹⁷

In summary, like the ICI, the SEC believes that a variety of information is important to most mutual fund investors. Also, like the ICI, the SEC believes that not only the substance of this information, but also its format, is important to investors. The SEC believes fund investors are more likely to understand clear, concise, and standardized disclosure of information in plain English or in graphical or tabular form.⁹⁸

Investors better understand and compare standardized disclosure.

Because of these beliefs, the SEC requires the prospectus (and the fund profile) to contain much summarized information in a standardized tabular or graphical format. For example, since 1988, the SEC has required the fund prospectus to include a fee table that itemizes all of a fund’s fees and expenses in a uniform way because it believes a table “can be understood easily and . . . facilitates comparison among funds.”⁹⁹ This requirement arose from the SEC’s concern that “investors could be confused if the increasing variety of sales loads and other fund distribution arrangements

⁹⁵ *Id.*

⁹⁶ *Id.* at 67,800.

⁹⁷ If requested by an investor, the fund would also have to send a copy of full, statutory prospectus by regular mail or email. *Id.* at 67,792.

⁹⁸ Registration Form Used by Open-End Management Investment Companies, 62 Fed. Reg. at 10,900 (“Investors have expressed a strong preference for summary information about funds in a standard format.”).

⁹⁹ DIVISION OF INVESTMENT MANAGEMENT, SECURITIES AND EXCHANGE COMMISSION, REPORT ON MUTUAL FUND FEES AND EXPENSES § II(A)(2) (Dec. 2000), <http://www.sec.gov/news/studies/feestudy.htm> (last visited Feb. 16, 2008) [hereinafter SEC FEE REPORT]. The table itemizes front and back-end loads, management fees, 12b-1 fees, and other fees and expenses. Form N-1A, *supra* note 68, at Item 3.

were not uniformly presented.”¹⁰⁰ In addition, the fee table must be accompanied by a listing of the dollar amount of fees and expenses that investors would pay during a one, three, five, and ten year period if they invested \$10,000 in the fund and the fund had a 5% annual return.¹⁰¹

The prospectus must also contain standardized, graphical and tabular information about the fund’s historical returns. A bar chart must show the fund’s annual returns during each of the last ten calendar years. In addition, the fund’s average annual returns over the previous one, five and ten calendar years must be displayed in a table.¹⁰² The table must also show the returns of “an appropriate broad-based securities market index ... over the same periods.”¹⁰³

According to the SEC, this bar chart and table serve multiple purposes. First, they help inform investors about the fund’s past returns, both in absolute terms and relative to an appropriate index. Also, by standardizing the past returns information, investors can compare the returns of other mutual funds – subject to the boilerplate caution that “the Fund’s past performance (before and after taxes) is not necessarily an indication of how the Fund will perform in the future.”¹⁰⁴

In addition, the SEC seeks to have the prospectus convey the volatility of the fund’s returns. The prospectus must include an explanation of how the bar chart and table of the fund’s past returns illustrate “the variability of the Fund’s returns (e.g., by stating that the information provides some indication of the risks of investing in the Fund by showing changes in the Fund’s performance from year to year and by showing how the Fund’s average annual returns for 1, 5, and 10 years compare with those of a broad measure of market performance).”¹⁰⁵

In addition, the SEC mandates the order of the information that must be disclosed. The prospectus’s organization reflects the SEC’s belief that investors are more likely to read information if it is presented prominently.

¹⁰⁰ SEC FEE REPORT, *supra* note 99 at § II(A)(2).

¹⁰¹ SEC, Form N-1A, *supra* note 68, at Item 3.

¹⁰² The fund’s returns before taxes, returns after taxes on distributions, and returns after taxes on distributions and sale of fund shares must each be presented in the table. *Id.* at Item 2.

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

In 1998, the SEC required the front part of prospectuses include a risk/return summary. This risk/return summary is intended to “function[] as a standardized ‘executive summary’ of key information about the fund.”¹⁰⁶ The summary includes the fund’s investment objectives or goals, its principal investment strategies, the fee table, and the bar chart and table showing past returns.¹⁰⁷ The placement of the summary at the beginning of the prospectus reflects the SEC’s belief that investors are more likely to read prominently placed information.¹⁰⁸ Similarly, the SEC requires that the information in the fund profile must be presented in a specified order. The SEC believes that “requiring the profile items in a specific sequence will substantially assist investors in locating information and comparing funds.”¹⁰⁹

Recognizing that comparing funds can be difficult, the SEC is also attempting to make the information in the current disclosure documents more accessible to investors. In June 2007, the SEC allowed mutual funds to file information in the risk/return summary of their prospectuses as interactive data. Using certain software, investors are be able to access this information and compare it across different mutual funds much more quickly than if they have to collect the data from the traditionally-filed prospectuses.¹¹⁰

Investors better understand plain English. The SEC has explicitly stated that it believes that investors are more likely to understand disclosure documents written in plain English: “preparing documents in

¹⁰⁶ *Transparency Hearings*, *supra* note 62 (statement of Arthur Levitt).

¹⁰⁷ Form N-1A, *supra* note 68, at Item 2.

¹⁰⁸ *Transparency Hearings*, *supra* note 62 (statement of Arthur Levitt) (requiring the fee table to be in the risk/return summary “reflects the Commission’s commitment to promoting investors’ access to fee information as a basis for a fund investment decision.”).

¹⁰⁹ New Disclosure Option for Open-End Management Investment Companies, 63 Fed. Reg. at 13,972.

¹¹⁰ Information filed as interactive data “will be tagged using eXtensible Business Reporting Language, or XBRL, so that it can be manipulated through the use of software tools to cull out specified information, such as cost data, for example.” *Mutual Funds: SEC to Allow Use of Interactive Data By Mutual Funds to Submit Risk/Return Info*, 39 Sec. Reg. & L. Rep. (BNA) 986 (June 25, 2007).

plain English increases investors' understanding and helps them make informed investment decisions."¹¹¹

Thus, to make prospectuses (and fund profiles) easier for investors to understand, in 1998, the SEC adopted a "Plain English Rule," which requires that a prospectus's cover page, risk/return summary, and risk factors section be written in "plain English."¹¹² The SEC summarized the plain English rule as requiring that, in these sections of the prospectus, issuers use "short sentences; definite, concrete, everyday language; active voice; tabular presentation of complex information; no legal or business jargon; and no multiple negatives" and requiring that these sections be designed "to make them inviting to the reader." To help issuers comply with the new rule, the SEC also produced an 83-page "Plain English Handbook" with specific guidelines on how to write in plain English.¹¹³

Summary and analysis. The content requirement of the prospectus and profile reflect the SEC's views regarding which fund characteristics are relevant to most mutual fund investors. These views largely mirror those of the ICI. The SEC's requirements regarding the required forms of the information also reflect the SEC's opinion, which is shared by the ICI, that how the information is presented affects whether investors will read and understand it.

Although aware of the difficulties that fund investors have in processing information, the SEC has shown incomplete concern about really helping investors understand their fund investment choices. In the 1998 prospectus disclosure rulemaking, the SEC acknowledged an ICI survey found that about half of fund investors do not read the prospectus before investing,¹¹⁴ but the SEC has not conducted a follow-up study on

¹¹¹ Plain English Disclosure, 63 Fed. Reg. 6,370, 6,371 (Feb. 6, 1998) (to be codified at 17 C.F.R. pt. 228, 229, 230, 239, 274). *See also*, SECURITIES AND EXCHANGE COMMISSION, A PLAIN ENGLISH HANDBOOK: HOW TO CREATE CLEAR SEC DISCLOSURE DOCUMENTS 3 (Aug. 1998), available at <http://www.sec.gov/pdf/handbook.pdf> [hereinafter PLAIN ENGLISH HANDBOOK] ("The benefits of plain English abound. Investors will be more likely to understand what they are buying and to make informed judgments about whether they should hold or sell their investments.").

¹¹² Although the plain English requirement applies to only certain parts of the prospectus, the entire prospectus is required to be "clear, concise, and understandable." Plain English Disclosure, 63 Fed. Reg. at 6,371.

¹¹³ PLAIN ENGLISH HANDBOOK, *supra* note 111.

¹¹⁴ Registration Form Used by Open-End Management Investment Companies, 63 Fed. Reg. at 13,917 n.5.

whether fund investors are reading or understanding the new streamlined prospectuses or fund profiles.

B. SEC Regulation of Fund Advertising

Mutual fund advertisements are also an important source of information for investors. In fact, investors invest more in heavily advertised funds.¹¹⁵ The SEC's rules regarding the content and form of fund advertisements, like its rules regarding prospectus and profile disclosures, reveals the agency's view of fund investors.

Investor warnings. One recurring theme of the advertising rules is that investors must be reminded to pay attention to certain important information when choosing a fund. To keep investors focused, the rules require that fund advertisements explicitly advise investors "to consider the investment objectives, risks, and charges and expenses of the investment company carefully before investing."¹¹⁶

The advertising rules also acknowledge that investors often become mesmerized by past performance, despite little evidence of a positive relationship between past and future returns.¹¹⁷ The SEC closely regulates advertising of a fund's past returns, which mutual funds with strong records routinely tout. In 2003, the SEC amended its rules governing advertisements that contain performance data.¹¹⁸ The SEC explained that the amendments "address[] our concern that some funds, when advertising their performance, may resort to techniques that create unrealistic investor expectations or may mislead potential investors. These concerns arose during 1999 and 2000 when many funds experienced extraordinary performance and engaged in advertising campaigns focusing on past performance."¹¹⁹

¹¹⁵ See *infra* pp. 54-56.

¹¹⁶ 17 C.F.R. § 230.482(b)(1)(i) (2008).

¹¹⁷ Funds highlight strong past returns for good reason: investors give great weight to past performance, even though there is little evidence that a fund's past performance predicts its future performance. See *infra* pp. 46-50.

¹¹⁸ The amendments were intended to ensure that performance advertisements contain current returns data and to ensure that fund advertisements include improved narrative information and present explanatory information more prominently. Amendments to Investment Company Advertising Rules, 68 Fed. Reg. at 57,763.

¹¹⁹ Amendments to Investment Company Advertising Rules, 68 Fed. Reg. at 57,760.

The SEC mandates boilerplate warnings in performance advertisements that high past returns may not continue. In particular, the advertisements must include a legend stating that “past performance does not guarantee future results; that the investment return and principal value of an investment will fluctuate so that an investor’s shares, when redeemed, may be worth more or less than their original cost; and that current performance may be lower or higher than the performance data quoted.”¹²⁰

Standardized performance data. In addition to downplaying the importance of past performance, the SEC requires that any performance information in advertisements be largely standardized. For example, the SEC prescribes how returns must be calculated¹²¹ and the time periods that must be reported.¹²² In addition, the advertisement must list “a toll-free or collect telephone number or a website where an investor may obtain performance data current to the most recent month-end, unless the advertisement includes [this information].”¹²³ The SEC’s rationale for requiring standardized performance information is that it is likely to encourage investor understanding of funds’ past returns and to facilitate comparing the returns of different funds.¹²⁴

Summary and analysis. The SEC’s regulation of advertisements reflects misgivings about investor decision-making. The SEC encourages investors to pay attention to certain key fund characteristics, apparently worrying that investors do not do so. Also, the SEC warns investors not to overfocus on past performance, apparently believing investors do so. Curiously, however, the SEC then requires standardized performance data, so investors can compare the performance of different funds.

¹²⁰ 17 C.F.R. § 230.482(b)(3)(i) (2008).

¹²¹ The rules regarding how to calculate past returns in advertisements are identical to those regarding how past returns must be calculated in the prospectus. 17 C.F.R. § 230.482(d) (2008).

¹²² The advertisements must report annual returns for one, five and ten years, current to the most recent quarter. 17 C.F.R. § 230.482(d)(3)-(4) (2008). Advertisements may also include other historical return measures, but these other measures may only supplement – not replace – the required measures. 17 C.F.R. § 230.482(d)(5) (2008).

¹²³ 17 C.F.R. § 230.482(b)(3)(i) (2008).

¹²⁴ As noted above, the SEC explains that it requires standardized fee and expense information in the prospectus to encourage investor understanding of these fees and expenses and facilitate comparisons of funds. *See supra* notes 91-92 and accompanying text.

Unlike its prospectus regulations, the SEC's advertising regulations may not reflect the SEC's view of the "typical" or "average" investor. Unlike fund prospectuses and profiles, advertisements regularly reach audiences that have not requested information about particular mutual funds, and thus may be less financially sophisticated than most investors. Also, as employer-based retirement savings increasingly move to defined-contribution plans invested in mutual funds, these new fund investors may dilute the financial sophistication of the "typical" or "average" investor.

As with its prospectus regulations, the SEC's advertising regulations are largely based on the agency's unsupported perceptions of the informational and cognitive needs of fund investors. In its rulemakings the SEC gives no indication why it believes investors need warnings and, more glaring, it gives no indication that it is examining whether these warnings are working.

C. SEC Efforts to Educate Investors

Besides requiring mutual fund companies to provide investors with certain information and warnings in prospectuses and advertisements, the SEC has also sought to directly educate fund investors. Indeed, the SEC has acknowledged it has an "important" role to play in this regard.¹²⁵ A 2000 study by the SEC's Division of Investment Management, called upon the Commission to continue its program to improve investor "financial literacy" regarding mutual funds and their costs.¹²⁶ In addition, the Division recommended that the Commission "develop educational materials" to help investors understand how to use any new fee disclosures that it requires funds to provide.¹²⁷

Warnings about past performance. To educate investors, the SEC has developed some basic materials in which the agency implicitly accepts that some mutual fund investors are prone to certain investing mistakes. Like the advertising regulations, the materials reflect the SEC's concern that investors overweight past fund returns. A document on the SEC website, *Invest Wisely: An Introduction to Mutual Funds*, gives investors a basic introduction to mutual funds and a stern warning (in plain English) against relying on past returns:

¹²⁵ SEC FEE REPORT, *supra* note 99 at § IV(A)(1) (Dec. 2000), <http://www.sec.gov/news/studies/feestudy.htm> (last visited Feb. 16, 2008).

¹²⁶ *Id.*

¹²⁷ *Id.*

Past performance is not a reliable indicator of future performance. So don't be dazzled by last year's high returns. . . . A fund's past performance is not as important as you might think. Advertisements, rankings, and ratings often emphasize how well a fund has performed in the past. But studies show that the future is often different. This year's "number one" fund can easily become next year's below average fund.¹²⁸

Other SEC publications also make the same point, but not as strongly. For example, another document on the SEC's website, *Mutual Fund Investing: Look at More Than a Fund's Past Performance*, warns investors that

[y]ou can't open a newspaper or read a magazine without seeing ads promoting the stellar performance of "hot" mutual funds. But past performance is not as important as you may think, especially the short-term performance of relatively new or small funds. As with any investment, a fund's past performance is no guarantee of its future success. Over the long-term, the success (or failure) of your investment in a fund also will depend on [other] factors. . . . So, look at more than the fund's past performance when making your investment decisions."¹²⁹

Warnings about fund expenses. The SEC's educational materials also indicate concern that some investors do not pay enough attention to fund expenses. The materials encourage investors who are choosing a mutual fund to give significant weight to fund expenses. For example, they describe the different types of fees and expenses,¹³⁰ encourage investors to "carefully review"¹³¹ and "scrutinize"¹³² the fees charged by funds they are considering, and warn investors that "[e]ven small

¹²⁸ SEC, *Invest Wisely*, *supra* note 2.

¹²⁹ Securities and Exchange Commission, *Mutual Fund Investing: Look at More Than a Fund's Past Performance*, <http://sec.gov/investor/pubs/mfperform.htm> (last visited Feb. 16, 2008) [hereinafter SEC, *Look at More*].

¹³⁰ SEC, *Invest Wisely*, *supra* note 2.

¹³¹ *Id.*

¹³² SEC, *Look at More*, *supra* note 221.

differences in fees can translate into large differences in returns over time.”¹³³

To make the effect of fees more concrete, the SEC presents an example of the effect over twenty years of a 1% annual difference in fees on a hypothetical \$10,000 investment.¹³⁴ Recall that this information is not required in fund prospectuses or advertisements. In addition, to help investors compare the expenses of different mutual funds, and to understand the impact of expenses over time, the SEC website contains a “Mutual Fund Cost Calculator” and a link to the NASD’s “Mutual Fund Expense Analyzer.”¹³⁵ Again, neither of these tools is required to be mentioned in fund prospectuses or advertisements.

Finally, the SEC’s website also encourages investors to pay attention to other basic fund characteristics. For example, it encourages investors to consider a fund’s risks and investment strategy, and how a fund fits with the investor’s own risk tolerance, long-term investment strategies, and diversified investment portfolio. But, as with the prospectus, there is no explanation about how investors’ should develop investment strategies or what constitutes a diversified portfolio.

Summary and analysis. As does its advertising regulations, the SEC’s educational materials indicate that the agency believes that at least some investors need to be reminded not to give too much weight to a fund’s returns and too little weight to other factors like a fund’s fees and expenses, risk, and investment objectives and strategies.

But as with the advertising regulations, the intended audience of the educational material on the SEC’s website is unclear. Much of the information is very basic, and titles such as “*An Introduction to Mutual Funds*” suggest that it is targeted to new investors rather than the typical investor. Nonetheless, the SEC has indicated that even most investors

¹³³ SEC, *Invest Wisely*, *supra* note 2. *See also*, Securities and Exchange Commission, *Calculating Mutual Fund Fees and Expenses*, <http://sec.gov/investor/tools/mfcc/mfcc-int.htm> (last visited Feb. 16, 2008) [hereinafter SEC, *Calculating Fees*] (“Fees and expenses are an important consideration in selecting a mutual fund because these charges lower your returns.”); SEC, *Invest Wisely*, *supra* note 2 (“[i]t is important that you understand [mutual fund fees and expenses] because they lower your returns.”).

¹³⁴ SEC, *Invest Wisely*, *supra* note 2 (“For example, if you invested \$10,000 in a fund that produced a 10% annual return before expenses and had annual operating expenses of 1.5%, then after 20 years you would have roughly \$49,725. But if the fund had expenses of only 0.5%, then you would end up with \$60,858 – an 18% difference.”).

¹³⁵ SEC, *Calculating Fees*, *supra* note 133.

may need to be reminded to make fully-informed investment decisions.¹³⁶ Overall, it is fair to conclude that at least the profile of the investor to whom the SEC's educational materials is directed is significantly less favorable than the profile of the mutual fund investor presented by the fund industry.

As with its rulemakings on prospectus disclosure and fund advertising, the SEC's educational push is largely oblivious to the academic literature profiling fund investors. For example, the agency makes no mention of (and has not engaged in) investor studies that show how much investors are aware of the effect of fund costs, the relationship of past and future returns, the difference in asset classes, the impact and meaning of diversification, and so on. Nor has the agency made any effort to learn whether its boilerplate warnings might have or are having any effect on investor behavior.

IV. ACADEMIC LITERATURE'S PROFILE OF FUND INVESTORS: MOSTLY CLUELESS

While the fund industry portrays fund investors as making informed decisions about mutual funds, and the SEC portrays fund investors as needing to only be reminded to pay appropriate attention to important fund characteristics, the academic literature portrays funds investors as ill-prepared to choose among mutual funds. Contradicting the industry's and regulator's favorable portraits, an extensive body of studies of actual investor behavior – conducted primarily by finance academics – reveals that fund investors are largely lost.

This finance literature finds that fund investors are mostly ignorant about the basic characteristics of the funds in which they invest. They are unaware of particular fund risks and regularly underestimate potential for losses. They largely ignore ongoing fund fees and expenses, although they have come to avoid one-time sales loads that are charged when entering a fund. In addition, they regularly buy funds based on strong past

¹³⁶ See, e.g., SEC FEE REPORT, *supra* note 99 at § II(B)(2) (The SEC “continues to be concerned . . . that the typical investor [is] not using all of the resources that are available in considering investments in mutual funds.”); Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, 69 Fed. Reg. 11,244, 11,245 (Mar. 9, 2004) (to be codified at 17 C.F.R. pt. 210, 239, 249, 270, 274) (“the degree to which investors understand mutual fund fees and expenses remains a source of concern.”).

performance, despite there being little correlation between past and future returns.

In short, mutual fund investors on the whole seem unable to perform the disciplining role that the industry says they do and that the SEC anticipates they should do. This is not surprising. By definition, investors in mutual funds have chosen to delegate portfolio management to an investment professional.¹³⁷ But, whether investing on their own or through an employer-provided retirement plan, fund investors must still choose in which funds to invest. The academic literature suggests that, to do this, fund investors need much more help than they are currently receiving.

This section describes the findings of the academic finance literature and contrasts the investor profile that this literature reveals with the profiles advanced by the ICI and the SEC.

A. Investors Are Ignorant of Fund Characteristics

Most fund investors do not know the basic characteristics of the mutual funds they own. A broad survey conducted in the 1990s found that mutual fund investors are “in general uninformed regarding the nature of their investments.”¹³⁸ Capon, Fitzsimons, and Rice conducted a random telephone survey of almost 3,400 households that invest in mutual funds. They found that 72% of the surveyed investors didn’t know if their primary fund invests in domestic or international securities, and 75% didn’t know whether the fund invests in equity or fixed income securities.¹³⁹ More recently, the ICI survey conducted in 2006 confirms these results, focusing on investors who own funds outside of employee-sponsored retirement accounts (and thus who likely are more wealthy and sophisticated than most fund investors).¹⁴⁰ Only 57% of investors in the ICI survey said that, before investing, they review the types of securities held by the fund and only 40% review the fund’s investment objectives.¹⁴¹

¹³⁷ Other reasons for investing in mutual funds include the ability to diversify with even a small investment, and the liquidity of mutual fund shares. SEC, *Invest Wisely*, *supra* note 2.

¹³⁸ Noel Capon, Gavan J. Fitzsimons, & Russ Alan Prince, *An Individual Level Analysis of the Mutual Fund Investment Decision*, 10 J. FIN. SERVICES RES. 59, 77 (1996).

¹³⁹ Capon et al., *supra* note 138, at 68.

¹⁴⁰ ICI, *INVESTOR PREFERENCES*, *supra* note 28, at 1.

¹⁴¹ *Id.* at 3 fig.1.

In addition, fund investors are often ignorant of key cost characteristics of their mutual funds. In Capon, Fitzsimons, and Rice's survey of mutual fund investors, 39% of the respondents said they didn't know whether their primary mutual fund had a load.¹⁴² In addition about half of those surveyed admitted to not knowing the expense ratio of their primary fund even when they purchased it.¹⁴³

Investor reaction to fund name changes also reflects general investor ignorance. A mutual fund's name often reflects its investment style, for example, by containing the word "growth" or "value."¹⁴⁴ Sometimes, a fund's name change suggests a change in its investment style. For example, the Armada Equity Fund changed its name to the Armada Equity Growth Fund.¹⁴⁵

In a recent study, Cooper, Gulen, and Rau examined investors' reactions to 332 such style name changes in equity mutual funds.¹⁴⁶ They found that funds that change their names to reflect a more popular investment style experience a large increase in flow (i.e., the aggregate amount that investors put into or withdraw from the fund during a particular period).¹⁴⁷ Particularly disturbing, is that this flow increase occurs even if the fund changes only its name, without actually changing its investment style.¹⁴⁸ Investor reaction to such "cosmetic" name changes further evidences that investors are not aware of the actual holdings of their mutual funds.

The ICI survey also reveals basic investor ignorance even about how mutual funds work. According to the survey, 58% of respondents said they reviewed the fund's net asset value ("NAV") before investing. The NAV is simply the value of the fund's holdings divided by the number of fund shares outstanding. The NAV should be irrelevant to rational

¹⁴² Capon et al., *supra* note 138, at 68.

¹⁴³ *Id.*

¹⁴⁴ Michael J. Cooper, Huseyin Gulen, and P. Raghavendra Rau, *Changing Names with Style: Mutual Fund Name Changes and Their Effects on Fund Flows*, 60 J. FIN. 2825, 2825-26 (2005).

¹⁴⁵ *Id.* at 2856.

¹⁴⁶ *Id.* at 2829 & tbl.1.

¹⁴⁷ *Id.* at 2853.

¹⁴⁸ *Id.* at 2855.

investors. The fund's NAV does not indicate the fund's merit; in fact, a fund can arbitrarily change its NAV by splitting its shares.¹⁴⁹

B. Investors Are Inattentive To Risk

Fund investors generally are not aware of fund risks and do not take them seriously.¹⁵⁰ A number of academic studies of investor behavior are at odds with the conclusions of the ICI survey, in which most respondents (61%) reported they review a fund's risks before investing, making "fund risks" the third most reviewed information by fund investors.¹⁵¹

Indifference to risk measures. In academic studies, fund investors consistently show a lack of understanding of, and indifference to, risk. In one recent academic survey, fund investors acknowledged not using standard measures of risk – such as beta¹⁵² or the standard deviation of the fund's returns – in evaluating a fund.¹⁵³ In another recent experiment by Wilcox, fund investors were asked to choose among hypothetical stock mutual funds differing in up to six characteristics: (1) the fund company's name; (2) the fund's load, (2) the fund's annual management fee (4) the fund's return during previous year, (5) the fund's average annual return during the previous 10 years, and (6) the fund's beta.¹⁵⁴ The experiment

¹⁴⁹ The high percentage of investors who claim to consider the NAV also might be evidence that investors are not answering the survey honestly. As discussed above, some investors might falsely claim to survey takers that they consider certain factors (such as NAV) before investing because they believe that good investors consider these factors. *See supra* p. 11 & n.37. Even if investors are lying about considering a fund's NAV, however, their answers show that they are not financially sophisticated enough to realize that the NAV should be irrelevant to an investor.

¹⁵⁰ This conclusion is also shared by professionals who work with investors. Michael A. Jones, Vance P. Lesseig, & Thomas I. Smythe, *Financial Advisors and Mutual Fund Selection*, 18 J. FIN. PLAN. 64, 68 (2005) ("the consensus among most academics and practitioners is that individual investors largely ignore risk as a decision factor.").

¹⁵¹ ICI, INVESTOR PREFERENCES, *supra* note 28, at 3 fig.1.

¹⁵² Beta is a measure of the correlation of a fund's returns with the stock market's returns. WILLIAM J. CARNEY, CORPORATE FINANCE: PRINCIPLES AND PRACTICE 105-08 (2005).

¹⁵³ *See e.g.*, Diane Del Guercio & Paula A. Tkac, *The Determinants of the Flow of Funds of Managed Portfolios: Mutual Funds v. Pension Funds*, 37 J. FIN. & QUANTITATIVE ANALYSIS 523, 528 (2002) (noting that a survey of investors found that only 14% "said they use standard deviation to measure risk, 10% use beta, and only 4% use an alpha or Sharpe measure.").

¹⁵⁴ Ronald T. Wilcox, *Bargain Hunting or Star Gazing? Investors' Preferences for Stock Mutual Funds*, 76 J. BUS. 645 (2003).

found that a fund's beta was the least important characteristic to investors.¹⁵⁵

In addition, fund investors seem indifferent to tracking error, a measure of diversifiable risk. A fund has less tracking error if its returns more closely match those of a relevant market benchmark.¹⁵⁶ Del Guercio and Tkac examined fund flows into a large sample of equity mutual funds managed by a total of 483 fund managers in 352 different fund families.¹⁵⁷ They found that fund flow is not negatively related to the fund's tracking error.¹⁵⁸ Because tracking error is a measure of diversifiable risk, its lack of negative influence on fund flows indicates that investors do not pay attention to whether a fund reduces even diversifiable risk. In contrast, pension funds, which are run by managers who are much more sophisticated than most mutual fund investors, put less money in mutual funds with greater tracking error.¹⁵⁹

Only weak reliance on risk ratings. Even though investors personally do not evaluate significantly a fund's risk, many investors say that they use published fund ratings or rankings – such as those from Morningstar – that often incorporate some measure of risk. The ICI survey, for example, found that 35% of investors review a fund's "rating from a mutual fund rating service" before purchasing the fund, and 19% call it "very important" to their final decision to invest.¹⁶⁰ Thus, risk might affect investors' behavior indirectly because it is incorporated in third-party advice that influences investors.¹⁶¹

¹⁵⁵ *Id.* at 650.

¹⁵⁶ Del Guercio & Tkac, *supra* note 153, at 525.

¹⁵⁷ *Id.* at 533.

¹⁵⁸ Depending on the measure of fund flow used, they found that tracking error either had a statistically insignificant effect on fund flow or a statistically significant *positive* effect on fund flow. *Id.* at 539.

¹⁵⁹ *Id.*

¹⁶⁰ ICI, INVESTOR PREFERENCES, *supra* note 28, at 10 fig.6.

¹⁶¹ Del Guercio & Tkac, *supra* note 153, at 525 (finding evidence that the positive relationship between fund flow and Jensen's alpha – a risk-adjusted performance measure – is due to a high correlation between Jensen's alpha and "widely available summary performance measures, such as Morningstar's star rating.").

But reliance on third-party advice doesn't appear to markedly increase investors' sensitivity to fund risk. Although there is a positive relationship between flow and funds' risk-adjusted returns, it is not as strong as the positive relationship between flow and non-adjusted returns,¹⁶² That is, fund investors pay much more attention to fund performance than to fund risk.

Summary and analysis. Fund investors do not seem to understand or appreciate risk. They are unaware of various measures of fund volatility and thus the range of possible gains and losses that these measures imply. In addition, risk doesn't play a large role in their choice of funds.

C. Investors Pay Insufficient Attention to Fees and Expenses

Fund investors also pay little attention to fund fees and expenses, particularly the regular costs that funds incur, such as management fees and trading costs. Overall, studies and surveys of the actual knowledge and behavior of fund investors show that fund fees and expenses matter little to investors. The conclusion of these studies is at odds with the self-reporting by fund investors in the ICI survey, which found that nearly three-quarters (74%) of those surveyed claimed to review fund fees and expenses before investing, making it the most commonly reviewed information.¹⁶³ The studies also suggest that the SEC's heavy reliance on the investors (i.e. "the market") to control fees and expenses is misguided.

Surveys of fund investors. Surveys of fund investors have shown that they give little weight to fund fees and expenses. For example, in a survey sponsored by the SEC and the Office of the Comptroller of the Currency of 2,000 randomly-selected mutual fund investors, only 19% of those surveyed could give even an estimate of the expenses of their largest mutual fund holding.¹⁶⁴ In addition, only 43% claimed to have known the fund's expenses at the time they first purchased the fund.¹⁶⁵

¹⁶² *Id.* at 525.

¹⁶³ ICI, INVESTOR PREFERENCES, *supra* note 28, at 3 Fig.1.

¹⁶⁴ Gordon J Alexander, Jonathan D. Jones, & Peter J. Nigro, *Mutual fund shareholders: characteristics, investor knowledge, and sources of information*, 7 FIN. SERVICES REV. 301, 309 (1998).

¹⁶⁵ *Id.* at 309-10.

Also, Capon et al. (noted above) surveyed almost 3,400 randomly-selected households that invest in mutual funds.¹⁶⁶ As part of that survey, the respondents were asked to rate the importance of nine particular factors in choosing a mutual fund. The ratings could range from one (“not at all important”) to five (“extremely important”). The respondents gave management fees an average rating of only 2.28, thus ranking it only fifth among the nine factors.¹⁶⁷

In addition, the Wilcox study (noted above) asked fund investors to choose among hypothetical stock mutual funds differing in up to six characteristics.¹⁶⁸ Investors chose the fund’s management fee as only the fourth most important factor to them, ahead only of the fund’s load and its beta.¹⁶⁹

These results stand in stark contrast to those of the ICI survey. One reason may be that the ICI surveyed only investors who own mutual funds outside of employment-related retirement plans; the other surveys contained no such limitation. Thus, as a group, the investors surveyed by the ICI are likely more wealthy, and thus more financially experienced and sophisticated than those in the other surveys.

Another possible (and perhaps more plausible) reason for the discrepancy is the difference in the questions asked. The ICI survey asked whether the investor “reviewed” a fund’s fees and expenses before investing, while the Capon et al. survey and the Wilcox study asked how “important” the fund’s fees were to the investor in choosing a fund. Investors could review a fund’s fees before investing, yet not give them much weight. This difference, however, would not reconcile the ICI survey’s findings with the findings of the SEC/Comptroller of the Currency survey that less than half of investors reported they knew the expenses of their largest fund’s expenses when they purchased the fund.

Studies of investor behavior. Like these surveys, other studies of investor behavior also find that investors do not consider fund fees and expenses important. In fact, the studies of how investors actually behave –

¹⁶⁶ Capon et al., *supra* note 138.

¹⁶⁷ Capon et al., *supra* note 138, at 66. The other factors were, in order of decreasing importance, the fund’s investment performance track record, fund manager reputation, number of funds in the family, responsiveness to inquiries, investment management style, additional features (checking, brokerage), confidentiality, and community service/charity record. *Id.*

¹⁶⁸ Wilcox, *supra* note 154.

¹⁶⁹ Wilcox, *supra* note 154, at 650 (2003). Recall that the other fund characteristics were the fund company’s name, the fund’s return during the previous year, and the fund’s return during the previous ten years.

rather than surveys relying on self-reported behavior – paint a portrait of fund investors who pay little attention to ongoing fund fees and expenses.

There is little evidence that fund expenses matter much to investors. In particular, studies of actual investor behavior have found no negative relationship between funds' expense ratios and flows.¹⁷⁰ For example, for diversified U.S. equity mutual funds from 1970 to 1999, Barber, Odean, and Zheng found “at best, no relation between operating expenses and flows and, at worse, a perverse positive relation between expenses and flows for large funds.”¹⁷¹ In addition, they examined the mutual fund purchases and sales made by customers of a large discount broker for 1991 to 1996. From this data they identified cases in which a mutual fund purchase followed a sale within three weeks. They found that, for these cases, the operating expenses of the purchased funds were generally higher than those of the funds that were sold, indicating that investors do not switch funds to reduce the expenses they are paying.¹⁷²

Nonetheless, some recent studies suggest that fund operating expenses may be becoming relevant to investors. A recent study looking at investor behavior from 1992-2001 found a negative relationship between flows and a fund *family's* average expense ratio (as opposed to the expense ratio of a particular fund in the family).¹⁷³ Thus a fund family's reputation for low-cost funds may be important to investors, even though specific fund choice is unaffected by fund costs.

Growth of lower-cost funds. Although many fund investors seem not to pay attention to fund expenses, lower-cost funds have been gaining market share over time. As a result, the expense ratios paid by most mutual fund investors have been declining. Although this decline may be due to economies of scale in mutual fund operations, it may also reflect that certain segments of the mutual fund market may have become more sensitive to fund fees and expenses.

A major reason for the decline in expense ratios is likely the increasing popularity of index funds. Index funds are funds that attempt to

¹⁷⁰ Recall that flow is the aggregate amount that investors put into or withdraw from the fund during a particular period.

¹⁷¹ Brad M. Barber, Terrance Odean, & Lu Zheng, *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows*, 78 J. BUS. 2095, 2107 (2005).

¹⁷² *Id.* at 2116.

¹⁷³ Steven Gallaher, Ron Kaniel, & Laura T. Starks, *Madison Avenue Meets Wall Street: Mutual Fund Families Competition and Advertising 3* (January 2006) (unpublished manuscript, available at <http://ssrn.com/abstract=879775>).

match, rather than beat the returns of a particular index, such as the S&P 500.¹⁷⁴ Thus management fees can be very low because, unlike the managers of actively managed funds, index fund managers are not required to identify and research particular stocks that they believe will perform well; they merely buy stocks that are part of the index.¹⁷⁵ In addition, index funds generally buy and sell securities far less often than most actively managed funds, resulting in much lower transaction costs.¹⁷⁶ As a result, the expenses of index funds are generally much lower than those of actively managed funds.¹⁷⁷

The growth of index funds is not surprising. The popular media has given increasing attention to the benefits of index funds, which generally outperform actively managed funds as a group. Recently, popular publications such as *Money* magazine and the “Getting Going” column in *The Wall Street Journal* have frequently touted the wisdom of buying index funds.¹⁷⁸ This message appears to be getting through to some investors.

Index funds, however, have always represented only a small portion of mutual fund investments. Index funds first became available in 1976, and by 1999 grew to hold 10% of equity mutual fund assets.¹⁷⁹ Unfortunately, index funds’ market share has remained at approximately 10% since then.¹⁸⁰ Therefore to the extent that existence of index funds indicate that some investors are sensitive to fund expenses, index funds’ small and unchanging market share indicate that such investors remain a small minority.

High-expense index funds. While the growth of index funds suggests that many fund investors became more aware of the importance of fund

¹⁷⁴ 4 TAMAR FRANKEL & ANN TAYLOR SCHWING, *THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISORS* § 31.02[J] (2008).

¹⁷⁵ BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* 360 (9th ed. 2007).

¹⁷⁶ *Id.* at 360.

¹⁷⁷ *Id.* at 359.

¹⁷⁸ *See, e.g.*, Penelope Wang & Walter Updegrave, *Funds for the Long Run*, *MONEY*, Feb. 1, 2008, at 69 (recommending that “index funds are the ideal foundation for your core portfolio.”); Jonathan Clements, *Getting Going*, *WALL ST. J.*, Feb. 16, 2005, at D1 (noting that index funds regularly outperform most actively managed funds).

¹⁷⁹ John C. Bogle, *Reflections on “Toward Common Sense and Common Ground?”*, 33 *J. CORP. L.* 31, 34 (2007).

¹⁸⁰ *Id.*

expenses, the continuing success of high-cost index funds provides further evidence that investors still under-weight fund expenses.

Although a rational investor might buy a high-expense actively-managed fund in hopes that the fund manager's strong stock picking skills will more than compensate for the higher expenses, a high-expense index fund makes little sense. Index funds do not attempt to pick high-performing securities, but rather just hold the securities in a specific market index. For example, S&P 500 index funds just attempt to match the returns of the S&P 500, a well known index of large companies' stocks. Thus – by definition – an index fund manager's stock picking skill is irrelevant. A rational index fund investor should buy the index fund that has the lowest expense ratio, because all index funds are holding essentially the same securities.

Strangely, however, this is not how many investors choose among index mutual funds. In a study by Elton, Gruber, and Busse of flows into different S&P 500 index funds from 1996 to 2001, they found that investors were not moving away from high expense index funds. Instead, “a large amount of new cash flow goes to the poorest-performing funds.”¹⁸¹ Also, new index funds that entered the market during the period covered by their study had higher expenses (0.77%, with a maximum of 2%) than did the average index fund (0.44%).¹⁸² In addition, during the same period, the decile of index funds with the highest expense ratios grew almost twice as quickly as the low-cost index funds.¹⁸³

In response, the fund industry has attempted to explain the success of high-expense index funds. A recent ICI publication argues that differences across index funds, such as the size of fund assets and average account balances, may explain much of the differences in their expense ratios.¹⁸⁴ Because many of funds' costs are relatively fixed, index funds with more assets enjoy economies of scale.¹⁸⁵ In addition, the cost of maintaining an individual investor's account is largely unrelated to the size

¹⁸¹ Wilcox, *supra* note 154, at 650.

¹⁸¹ Edwin J. Elton, Martin J. Gruber, and Jeffrey A. Busse, *Are Investors Rational? Choices among Index Funds*, 59 J. FIN. 261, 286 (2004).

¹⁸² *Id.* at 286.

¹⁸³ *Id.*

¹⁸⁴ Sean Collins, *Are S&P 500 Index Mutual Funds Commodities?*, 11 INVESTMENT COMPANY INST. PERSP. 5 (Aug 2005), available at <http://www.ici.org/pdf/per11-03.pdf>.

¹⁸⁵ *Id.* at 6.

the account, so a fund with many small accounts is more costly to operate than a similarly sized fund with fewer, yet larger, accounts.¹⁸⁶ Although this may help explain why a small index fund with low average account balances is forced to charge a relatively high expense ratio, however, the ICI does not explain why an investor would choose such a fund when identical, lower-cost alternatives exist.

In the same publication, the ICI also argues that fund investors may choose high-cost index funds because such funds offer better services to investors.¹⁸⁷ Mutual funds can offer services, such as financial advice, lower minimum account balances, and lower account maintenance fees.¹⁸⁸ Although plausible, a recent experiment by Choi, Laibson, and Madrian casts great doubt on the conclusion that service differences explain investor choices. The study finds that even many intelligent and financially sophisticated investors would choose high-expense index funds even if the services offered by all index fund were identical. In the experiment, Wharton MBA and Harvard College students were presented with the prospectuses of four S&P 500 index funds with different expense ratios, and were asked to allocate an investment among these funds.¹⁸⁹ Participants could maximize their expected compensation for participating in the experiment if they picked the fund with the highest future return, which for index funds is the fund with the lowest expense ratio.¹⁹⁰ The experiment design meant that participants did not benefit at all from any fund services; all that mattered were returns (and thus expenses).¹⁹¹

Nevertheless, more than 95% of the participants failed to pick the portfolio that would minimize their expenses.¹⁹² In fact, as a whole, they chose portfolios that had expenses only slightly below the average expense ratio of the four funds.¹⁹³ Wharton MBA and Harvard College students

¹⁸⁶ *Id.*

¹⁸⁷ *Id.* at 5-10.

¹⁸⁸ *Id.* at 5.

¹⁸⁹ James J. Choi, David Laibson, & Brigitte C. Madrian, Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds 7-8 (May 2006) (unpublished manuscript, available at <http://www.som.yale.edu/faculty/jjc83/fees.pdf>).

¹⁹⁰ *Id.* at 3, 21-22.

¹⁹¹ *Id.*

¹⁹² *Id.* at 3.

¹⁹³ *Id.*

are unlikely, as a group, to be less financially sophisticated than most mutual fund investors. Thus, this experiment suggests that fund investors are not choosing high-expense index funds because these funds provided more services.

Summary and analysis. A large body of empirical evidence indicates most fund investors are unaware of the negative effect of fund expenses on their funds' performance, and they do not pay attention to such expenses in making investment decisions. Nonetheless, there are some indications that some fund investors are becoming more savvy about mutual fund expenses. The increasing popularity of index funds is a sign that many investors have come to notice that expenses create a drag on fund returns. Even though index funds have grown in popularity, however, investors still generally do not make expenses a major factor in their fund choices. Many continue to buy expensive actively-managed funds, and even many index fund investors purchase high-expense index funds.

D. Investors (Increasingly) Pay Attention to Loads

Many fund investors, although generally insensitive to fund expenses, increasingly pay attention to fund loads, which were once prevalent in the fund industry and have now become the exception.¹⁹⁴ A load represents a one time fee paid by investors when they buy (or sometimes when they sell) fund shares.¹⁹⁵ Loads are used to cover marketing costs, such as commissions to brokers that direct customers to particular funds.¹⁹⁶

Studies on loads. Do loads increase or decrease fund flows? On the one hand, investors should be averse to paying additional fees, and one

¹⁹⁴ In 2006, flows into load funds constituted only 16.2% of all flows into long-term mutual funds (i.e. equity, bond, and hybrid funds). This is a significant decline even from as recently as 2000, when they constituted 30.6% of flows into long-term mutual funds. 2007 FACT BOOK, *supra* note 4, at 21 & fig.2.7.

¹⁹⁵ For example, if a fund charges a 2% front-end load, a person who invests \$10,000 in the fund will only have \$9,800 invested in the fund.

¹⁹⁶ Investors could benefit if the greater marketing paid for by the load leads to an increase in the funds assets and the resulting economies of scale are passed along to the fund investors in the form of lower expenses. However, there is little evidence that loads actually lead to a net benefit for investors in this way. *See, e.g.*, Barber et al., *supra* note 171, at 2103 (finding that "although low expense funds have higher front-end-load fees than high expense funds, the relation between expenses and front-end loads is far from monotonic. In addition, front-end-load funds have higher average expense ratios than funds without front-end loads.").

would expect a negative relationship between loads and fund flow. On the other hand, load proceeds are used to market the fund, and additional marketing might offset investor aversion to expenses.

One earlier study found no relationship between loads and fund flow. In a study by Sirri and Tufano of equity mutual funds from 1971-1990, the aversion to loads seemed to roughly offset the effect of additional marketing.¹⁹⁷ A more recent study by Barber, Odean, and Zheng examining U.S. equity funds from 1970-99, however, finds a negative relationship between loads and flow.¹⁹⁸ Nonetheless, another recent study by Gallaher, Kaniel, and Starks found a positive relationship between the presence of load funds in a fund family and fund flows into that family.¹⁹⁹ Their study also found, however, that fund flow into the family was negatively related to the size of load.²⁰⁰ These findings may indicate that having any size load encourages brokers to sell the fund – which increases flow – but investors’ aversion towards loads increases as the load increases.²⁰¹

Thus, fund investors seem to be paying more attention to loads than they do to ongoing fund expenses. Wilcox’s experiment (discussed above) confirms this conclusion. Recall that the experiment required investors to choose among hypothetical stock mutual funds with different characteristics, including different expense ratio and load combinations. The investors greatly overemphasized loads compared to expense ratios, suggesting a “strong aversion to front-end loads and a commensurate disregard for annual expense ratios.”²⁰²

Although fund investors generally are more sensitive to loads than expenses, many investors still don’t pay attention to loads. In the survey by Capon, Fitzsimons, and Rice of almost 3,400 households that invest in mutual funds, 39% of respondents stated they did not even know if their primary mutual fund has a load.²⁰³ In addition, in Wilcox’s experiment

¹⁹⁷ Erik R. Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. Fin. 1589, 1612 (1998).

¹⁹⁸ Barber et al., *supra* note 171, at 2107.

¹⁹⁹ Gallaher et al., *supra* note 173, at 3.

²⁰⁰ *Id.*

²⁰¹ *Id.* at 14-15.

²⁰² Wilcox, *supra* note 154, at 654.

²⁰³ Capon et al., *supra* note 138, at 68.

requiring investors to choose among hypothetical mutual funds, the fund's load was only the fourth most important factor (of six) to investors – ahead of the fund's management fee and beta, but behind the fund's return over the past ten years, the fund's return over the past year, and the fund company's name.²⁰⁴

Rule 12b-1 fees. For fund investors, out of sight seems to mean out of mind – at least when it comes to marketing expenses. Fund investors seem not to pay attention to 12b-1 fees, ongoing marketing fees deducted over time from the fund's assets. Like loads, 12b-1 fees are used to pay broker commissions and other marketing costs, but unlike loads are not a large one-time fee deducted directly from investors' individual accounts.

Studies indicate that investors are much less averse to 12b-1 fees than to other types of loads. Barber, Odean, and Zheng examined the effect of 12b-1 fees flows into diversified, U.S. equity mutual funds from 1993 to 1999. Unlike their findings for loads, they found a positive relationship between 12b-1 fees and flows, indicating that the marketing benefits from using the proceeds of 12b-1 fees outweigh investors' aversion to paying these additional fees.²⁰⁵

Summary and analysis. Investors may be more sensitive to loads, than to other expense charges, because much of the popular financial media have been encouraging investors to avoid funds with loads.²⁰⁶ In fact, experienced investors are less likely to buy load funds than are other investors, providing support for this hypothesis.²⁰⁷ But this explanation is not completely satisfactory, because the financial media has also been emphasizing the benefits of lower-expense funds,²⁰⁸ yet more experienced fund investors do not buy lower-expense funds than do other investors.²⁰⁹

²⁰⁴ Wilcox, *supra* note 154, at 654.

²⁰⁵ Barber et al., *supra* note 171, at 2108.

²⁰⁶ See, e.g., George Mannes, *The Answer Guy*, MONEY, Feb. 2007, at 67.

²⁰⁷ Barber et al., *supra* note 171, at 2113.

²⁰⁸ See, e.g., Asa Fitch, Amanda Gengler, Josh Hyatt, & Ismat Sarah Mangla, *35 Minutes to Riches*, MONEY, Sept. 2007, at 80 (presenting a table entitled "How the Stingy Get Rich," showing that a low expense stock fund (0.2% annual expenses) will save an investor \$10,329 in expenses on a \$10,000 investment over twenty years compared to a high expense stock fund (1.5% annual expenses)).

²⁰⁹ Barber et al., *supra* note 171, at 2113. Note that this also is evidence that higher expense funds do not provide more services than do low-expense funds. Because they have investing experience, experienced investors likely have less need for some services

A more likely explanation is that loads are more salient and larger than operating expenses, which are “smaller ongoing fees that are easily masked by the volatility of equity returns.”²¹⁰ When an investor buys a fund with a front-end load, the investor sees the effect of the load quickly and vividly. The investor’s initial account statement will show less money than the investor sent to the fund company. On the other hand, the investor never directly sees the effect of fund operating expenses; instead, the effect appears only in the form of reduced returns over time. As a result, investors tend to underestimate the effect of operating expenses relative to loads. This type of behavior is analogous to people overemphasizing initial product costs versus ongoing annual costs. For example, people choosing printers are influenced more by the initial cost of the printer than the even greater cost, over time, of the type of ink the printer requires.

This explanation also finds support in fund investors’ lower aversion to 12b-1 fees than to loads. Like operating expenses, 12b-1 fees are smaller, ongoing charges deducted from fund assets rather than directly from investors’ accounts. That is, fund investors notice when they are struck by a club, but not when they’re slowly bled to death.

E. Investors Chase Past Returns

Although mutual fund investors pay little attention to a fund’s risk and operating expenses, they pay great attention to a fund’s historical returns. Surveys of investors and studies of their actual behavior find that this may be the most prominent component of the most fund investors’ profiles.

Investor surveys and experiments. Surveys and experiments gauging investor views uniformly identify the importance of a fund’s past returns. For example, Wilcox’s experiment requiring investors to choose between hypothetical mutual funds found that a fund’s returns over the past ten years and over the past year are the two most important factors to investors.²¹¹

(such as financial advice and low minimum balance requirements) than do inexperienced investors.

²¹⁰ Barber et al., *supra* note 171, at 2097.

²¹¹ Wilcox, *supra* note 154, at 650. Recall that the other factors were the fund company’s name, load, expense ratio, and beta.

Also, the survey by Capon, Fitzsimons, and Rice of households that invest in mutual funds found that a fund's "investment performance track record" is the most important factor in investors' choice of funds.²¹² In addition, the ICI survey of fund investors found that 69% of respondents stated they reviewed a fund's "historical performance" before investing in a fund.²¹³

Studies of actual investor behavior. Similarly, numerous studies of actual investor behavior have found that investors flock to mutual funds with the highest past returns. For example, Del Guercio and Tkac examined flow into a large sample of equity mutual funds.²¹⁴ They found that a fund's past return has a strong positive effect on flow into the fund.²¹⁵ In addition, this positive relationship was strongest for funds with the highest returns, indicating that investors especially chase the highest returns.²¹⁶ Similarly, the study by Sirri and Tufano of flow into equity mutual funds found that having higher returns garnered a fund more flow. This was especially true for the highest performing quintile of funds, showing again that investors flock to funds with the strongest past performance.²¹⁷

The tendency of investors to chase returns manifests itself not only in buying specific high-performance funds, but also extends to buying the types of funds that have recently performed well. As Cooper, Gulen, and Rau's study (discussed above) found, when a fund changes its name to reflect a hotter investment style, it receives a dramatic increase in flow.²¹⁸ This increase in flow occurs even if the fund doesn't actually change to the investment style suggested by the name change.²¹⁹

Although investors flock to funds that have produced the highest returns, there is little reason for them to do so. Despite numerous studies

²¹² Capon et al., *supra* note 138, at 66 .

²¹³ ICI, INVESTOR PREFERENCES, *supra* note 28, at 3 Fig.1.

²¹⁴ Del Guercio & Tkac, *supra* note 153, at 533.

²¹⁵ *Id.* at 525. They used the fund's excess return (i.e., the extent to which it outperforms the S&P 500) as the measure of the fund's return. *Id.* at 539.

²¹⁶ *Id.* at 525.

²¹⁷ Sirri & Tufano, *supra* note 197, at 1599.

²¹⁸ Cooper et al., *supra* note 144, at 2853.

²¹⁹ *Id.* at 2855.

testing the relationship between past performance and future returns, “within the finance literature there is [only] weak and controversial evidence that past performance has much, if any, predictive ability for future returns.”²²⁰ In other words, there is little evidence of returns persistence; top performing funds generally do not continue to outperform other funds. Most studies have shown that there is no returns persistence in the long-run. Nonetheless, there is some evidence of small, short-term returns persistence, i.e., funds that have performed well continue to outperform other funds in the short term.²²¹ But even this short-term persistence may not be meaningful to investors picking among mutual funds. An investor who tried to chase such short-term returns may well end up underperforming other investors because of resulting transaction charges and capital gains taxes from frequently buying and selling funds.²²²

Interestingly, in one survey, most mutual fund investors appeared to indicate that they realized that past performance was not predictive of future performance. In a joint survey by the SEC and the Office of the Comptroller of the Currency of 2,000 mutual fund investors, 71% of those surveyed expected that a fund with “good performance” in the previous year would have only “about average” performance the next year.²²³ Yet, as noted above, investors continue to put great weight on a fund’s past returns despite this.²²⁴

²²⁰ Wilcox, *supra* note 154, at 651. See also Jonathan B. Berk & Richard C. Green, *Mutual Fund Flows and Performance in Rational Markets*, 112 J. POL. ECON. 1269, 1270 & n.1 (2004) (“The relative performance of mutual fund managers appears to be largely unpredictable from past relative performance. . . . While some controversial evidence of persistence [of mutual fund returns] does exist. . . . it is concentrated in low-liquidity sectors or at shorter horizons.”) (footnote and citations omitted).

²²¹ For a summary of studies of returns persistence, see Nicolas P.B. Bollen & Jeffrey A. Busse, *Short-Term Persistence in Mutual Fund Performance*, 18 REV. FIN. STUD. 569, 570 (2005).

²²² *Id.* at 587-88. Many mutual funds charge front-end or back-end (i.e., deferred) loads that investors must pay when they buy or sell fund shares, respectively. Also, to discourage short-term trading, many mutual funds impose fees on investors who sell shares soon after buying them. In addition, when an investor sells mutual fund shares for a gain, the investor must pay capital gains taxes. Investors who sell fund shares less than one year after buying them pay a higher capital gains tax rate than do investors who hold the shares for more than one year. *Id.* at 595.

²²³ Alexander et al., *supra* note 164, at 309-11 & tbl.5.

²²⁴ In addition, although most of those surveyed claimed to expect only “about average” performance, more than four times as many of the surveyed investors expected that such a

A recent experiment also demonstrated the extent to which investors will irrationally chase high returns. In the experiment by Choi, Laibson, and Madrian, which asked Wharton MBA and Harvard undergraduate students to choose among S&P 500 index funds with different expense ratios and different inception dates, participants were mesmerized by past returns.²²⁵ In the experiment the higher-expense funds had higher past annualized returns, but only because they had different inception dates than the other funds.²²⁶ Participants nonetheless chose the index funds that had the higher past returns, even though these higher-expense funds would (by definition) be outperformed in the future by the lower-expense funds.²²⁷

Summary and analysis. In choosing mutual funds, investors give too little weight to important factors such as a fund's risk and ongoing expenses. But they cannot seem to help themselves from giving too much weight to past returns, a factor with little predictive value for future returns.

The tendency of investors to put too much emphasis on a fund's past returns may reflect a cognitive bias that is manifested in the *representativeness heuristic*.²²⁸ In other words, fund investors trying to predict whether a fund will perform well in the future will give great weight to how it has performed in the past – they assume that “past is prologue.”²²⁹

The representativeness heuristic also may help explain fund investors' choice of asset classes. Investors tend to be optimistic about future stock

fund would have “above average” performance than “below average performance” (24% vs. 5%). *Id.* at 309-11 & tbl.5.

²²⁵ Choi et al., *supra* note 189. A fund's inception date is the date it begins operations.

²²⁶ *Id.* at 4.

²²⁷ *Id.*

²²⁸ In general, the representativeness heuristic means that “when people try to determine the probability that a data set A was generated by model B . . . they evaluate the probability by the degree to which A reflects the essential characteristics of B.” Nicholas Barberis & Richard Thaler, *A Survey of Behavioral Finance*, in *HANDBOOK OF THE ECONOMICS OF FINANCE* 1051, 1064 (G.M. Constantinides, M. Harris, & R. Stulz eds., 2003).

²²⁹ In the terms of the representativeness heuristic, the “data set A” is the fund's high past returns, and the “model B” is a fund that has better chance of producing high returns than do other mutual funds. Investors using the representativeness heuristic will incorrectly assume that past high returns are likely to continue in the future because high past returns are a characteristic of a fund that produces high returns in general.

prices during bull markets and pessimistic about them during bear markets.²³⁰ Thus, it is unsurprising that aggregate fund flows into equity mutual funds increase following stock market increases.²³¹ Unfortunately, this behavior is unwise. Future returns do not tend to be higher following market rises than market declines.²³²

F. Financial Advisers Provide Little Help

Many investors consult a professional financial adviser before buying a mutual fund. Little evidence exists, however, that these advisers provide tangible benefits to investors, and investors pay a high price for using advisers. On balance, therefore, fund investors in general may actually be worse off using professional advisers.

Widespread use of financial advisers. Many investors outside of employer retirement plans use financial advisers. The ICI survey found that a professional financial adviser is the most common source of information consulted by mutual fund investors, with 73% of those surveyed responding that they consulted a professional financial adviser before buying a fund.²³³ Other researchers have made similar findings. For example, the survey by Capon, Fitzsimons, and Rice of households that invest in mutual funds survey found that – of nine sources of information – investors identified commission-based financial advisers as their third most important information source, and fee-based financial advisers as their seventh most important.²³⁴

At first glance, the widespread use of financial advisers by mutual fund investors is encouraging. Although most investors are not financially sophisticated, many are receiving professional advice that

²³⁰ Werner P.M. De Bondt, *Betting on Trends: Intuitive Forecasts of Financial Risk and Return* 9 INT'L. J. FORECASTING 355 (1993).

²³¹ Jason Karceski, *Returns-Chasing Behavior, Mutual Funds, and Beta's Death*, 37 J. FIN. & QUANTITATIVE ANALYSIS 559, 577-79 (2002)

²³² *Id.* at 584.

²³³ ICI, INVESTOR PREFERENCES, *supra* note 28, at 4 Fig.2.

²³⁴ Capon et al., *supra* note 138, at 66 tbl.1. Differences between the questions asked in this survey and the ICI survey make exact comparisons of the results impossible. For example, the ICI survey did not distinguish between commission-based and fee-based financial advisers. Also, the ICI asked investors whether they used a particular information source; Capon et al. asked investors to rate the importance of a particular information source.

could help them overcome their limitations. In doing so, professional advisers may help investors provide market discipline over mutual funds. Before reaching such a conclusion, however, financial advisers' behavior must be understood.

Survey of financial advisers. A recent survey by Jones, Lesseig, and Smythe of 530 professional financial advisers asked them the importance that fourteen fund characteristics played in their recommendations of mutual funds to their clients.²³⁵ First, the good news. Financial advisers ranked the fund's objective as the second most important factor in their recommendations.²³⁶ This is much greater emphasis than investors give to a fund's objective. For example, the ICI survey found that only 40% of investors review a fund's objective before investing,²³⁷ and Capon, Fitzsimons, and Prince's survey found that most investors were not even aware of the types of securities their funds hold.²³⁸

In addition, financial advisers ranked a fund's risk as the third most important factor.²³⁹ This contrasts with the actions of investors, who generally pay little attention to a fund's risk. Thus, to the extent that investors heed the advice of their financial advisers, investors may buy funds that are better suited to their financial objectives and risk tolerances.

Unfortunately, other results of the survey of financial advisers are less encouraging. Financial advisers admit to putting less emphasis on a fund's cost to their clients. For example, advisers ranked a fund's expenses (excluding commissions) as only the eighth most important factor among the fourteen examined.²⁴⁰ In addition, a fund's load and 12b-1 fee were the least important factor to advisers.²⁴¹ This last finding should not be surprising; mutual funds often use loads and 12b-1 fees to compensate financial advisers for directing their clients to the funds. Thus, the survey

²³⁵ Jones et al., *supra* note 150.

²³⁶ *Id.* at 68.

²³⁷ ICI, INVESTOR PREFERENCES, *supra* note 28, at 3 fig.1.

²³⁸ Recall that 72% of the surveyed investors didn't know if their primary fund invests in domestic or international securities, and 75% didn't know whether the fund invests in equity or fixed income securities. Capon et al., *supra* note 138, at 68.

²³⁹ Jones et al., *supra* note 150, at 68.

²⁴⁰ *Id.* Also, a fund's tax efficiency – which can also effect investors' returns – was only the ninth ranked factor. *Id.*

²⁴¹ *Id.*

indicates that financial advisers may make investors even less sensitive to loads, fees, and expenses than investors would be on their own.

In addition, like investors, financial advisers place great emphasis on the fund's past returns. Advisers in the survey ranked a fund's "Performance Relative to Other Funds with Similar Style" as the most important factor and ranked the "Absolute Fund Performance" sixth.²⁴² Thus, within a group of similar funds, financial advisers give high priority to those that have performed well in the past. As discussed above, such a fund-picking strategy is unwise; past performance is at best a weak predictor of future performance.

Advisers' effects on actual investor behavior. Studies have also looked at the actual effects of financial advisers on investors. An extensive study by Bergstresser, Chalmers, and Tufano compared fund choices from 1996-2004 for investors who bought funds through direct channels with those who bought through brokers.²⁴³ They found that brokers direct investors toward funds with higher front-end loads and 12b-1 fees.²⁴⁴ Also, they found that the larger a fund's load and 12b-1 fee, the more flows it receives from investors using brokers.²⁴⁵ Because mutual funds often use loads and 12b-1 fees to compensate brokers, these findings indicate that brokers direct investors to funds that offer the brokers more compensation.

As a result, investors pay a steep price for using brokers. It has been estimated that, in 2002, investors paid up to \$3.6 billion in front-end loads, \$2.8 billion in back-end loads, and \$8.8 billion in 12b-1 fees.²⁴⁶ Unfortunately, there is little evidence that fund investors receive commensurate benefits from brokers. Bergstresser, Chalmers, and Tufano found that funds purchased through brokers tend to underperform funds that investors buy directly, even before taking into account the higher

²⁴² *Id.*

²⁴³ For 2004, their sample covered 4,253 mutual funds with assets of \$5.1 trillion. Daniel Bergstresser, John M.R. Chalmers, & Peter Tufano, *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry* 7 (Harvard Bus. Sch. Fin. Working Paper No. 616981, 2007), available at <http://ssrn.com/abstract=616981>. Note that many, but not all, brokers provide advice regarding which funds investors should purchase. In addition, some financial advisers do not provide broker services to their clients.

²⁴⁴ *Id.* at 17.

²⁴⁵ *Id.* at 17-18.

²⁴⁶ *Id.* at 2.

distribution-related expenses of broker channel funds.²⁴⁷ This underperformance exists in both absolute returns and in risk-adjusted returns.²⁴⁸ They estimate that this underperformance cost investors approximately another \$4.6 billion in 2004 alone.²⁴⁹

Also, they found no evidence that “brokers provide superior asset allocation advice that helps their investors time the market.”²⁵⁰ The asset allocation choices made through broker-channel funds did not earn higher absolute or risk-adjusted returns than did funds bought through direct channels.²⁵¹

In theory, investors who buy funds through brokers, thus paying higher distribution expenses in the form of loads and 12b-1 fees, might still benefit if broker channel funds have lower non-distribution expenses (such as management fees) than do other funds. That is, paying for fund marketing to attract new investors and bring in more assets might be worthwhile if, as a result, the fund gained economies of scale and passed them through to existing investors.²⁵² Unfortunately, Bergstresser, Chalmers, and Tufano found that funds bought through brokers do not have lower non-distribution expenses, so investors do not benefit in this way either.²⁵³

Brokers help with some cognitive biases. There is some evidence that brokers help investors at least partially overcome their “home bias,” a well-known tendency of investors to disproportionately buy assets located geographically close to them and to underweight foreign and distant domestic assets.²⁵⁴ Bergstresser, Chalmers, and Tufano found that

²⁴⁷ *Id.* at 9-10.

²⁴⁸ *Id.* at 8-9.

²⁴⁹ *Id.* at 9-10.

²⁵⁰ *Id.* at 12.

²⁵¹ *Id.* at 11-12.

²⁵² GAO, MUTUAL FUND FEES, *supra* note 62, at 9 (“Academic studies and other research find that as mutual fund assets grow, mutual fund advisers experience operational efficiencies or economies of scale that would allow them to reduce their funds’ expense ratios.”).

²⁵³ Bergstresser et al., *supra* note 243, at 13-14.

²⁵⁴ *Id.* at 15.

investors using brokers buy funds that hold a greater percentage of foreign assets than do other investors.²⁵⁵

Similarly, brokers appear to direct investors to smaller funds and younger funds than investors would find on their own.²⁵⁶ But, as discussed above, this doesn't appear to give investors better returns or lower expenses than investors who buy through direct channels receive.

In addition, brokers do not help investors alleviate other behavioral biases. For example, brokers do not reduce investors' chasing of past performance; investors who buy funds through brokers are as likely to chase "hot" funds as are investors who buy through direct channels.²⁵⁷

Summary and analysis. Surveys have shown that many investors follow the advice of financial advisers when picking a mutual fund. But this should not give comfort to regulators. There is little evidence that financial advisers provide tangible benefits to fund investors or help them provide market discipline over mutual funds.

Nonetheless, financial advisers might benefit investors in other ways that have not been studied. For example, they "may help their clients save more than they would otherwise save, they may help clients more efficiently use their scarce time, they may help customize portfolios to investors' risk tolerances, and they may increase overall investor comfort with their investment decisions."²⁵⁸ Still, even if such benefits exist, they do not help provide the market discipline over mutual funds upon which the SEC's disclosure-based regime relies.

H. Advertising Doesn't Benefit Investors

In addition to financial advisers, investors pay attention to mutual fund advertisements. Unfortunately, these advertisements do not help investors make better fund choices. Instead, advertisements tend to exploit the tendency of investors to chase past returns.

Importance of advertising. In Capon, Fitzsimons, and Prince's survey, fund investors stated that advertising was their second most

²⁵⁵ *Id.*

²⁵⁶ *Id.* at 13. Another indication that brokers direct investors to less well known mutual funds is that funds bought through brokers are less likely to be covered by Morningstar than are funds investors buy directly. *Id.*

²⁵⁷ *Id.* at 15-16.

²⁵⁸ *Id.* at 2-3.

important source of information.²⁵⁹ Advertising's importance to investors is confirmed by studies finding that mutual fund advertising works. For example, Jain and Wu examined fund flows into 294 equity mutual funds that advertised in *Barron's* or *Money* magazines. They found that these advertised funds experienced approximately 20% greater flow than did similar funds that did not advertise.²⁶⁰ In addition, they found that funds that are advertised more often receive even more flow.²⁶¹

Similarly, Gallaher, Kaniel, and Starks examined the effect of advertising on flows into approximately 100 fund families. They found that the effect of advertising on flows into fund *families* is convex: “[h]igh relative levels of advertising are significantly related to high fund flows at the family level, while variations of relative levels of advertising within the low advertising group do not have a significant impact on flows to the family.”²⁶² That is, fund investors respond to advertising inundation.

Benefits and harms of advertising. Advertising clearly benefits mutual fund management companies. Management fees are based on the amount of assets in the fund, so advertising can increase management fees by increasing flow. There is little evidence, however, that advertising benefits investors as well. Jain and Wu found that advertised funds tend to have significantly outperformed their relevant benchmarks in the year prior to the advertisements,²⁶³ but after being advertised, the funds tend to underperform the same benchmarks.²⁶⁴

In addition, advertising may also have a disturbing side effect on other sources of mutual fund information. Mutual fund families often advertise in personal finance magazines, and there is evidence that these advertising expenditures bias the mutual fund recommendations of these magazines. In particular, Reuter and Zitzewitz found that a fund's family's advertising expenditures increased the probability that the family's funds are recommended in each of three popular personal finance

²⁵⁹ Capon et al., *supra* note 138, at 66 tbl.1.

²⁶⁰ Prem C. Jain & Joanna Shuang Wu, *Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows*, 55 J. FIN. 937, 957 (2000).

²⁶¹ *Id.*

²⁶² Gallaher et al., *supra* note 173, at 31.

²⁶³ Jain & Wu, *supra* note 260 at 956). *But see*, Gallaher et al., *supra* note 173, at 44 (finding a relationship between the past returns of fund *families* and the amount of advertising only for small, low- performing fund families).

²⁶⁴ Jain & Wu, *supra* note 260 at 956.

magazines: *Money*, *Kiplinger's Personal Finance*, and *SmartMoney*.²⁶⁵ Thus, advertising can bias what investors may perceive as unbiased advice. Interestingly, however, this bias likely causes little, if any, harm to investors because the future returns of these biased fund recommendations are similar to the returns of those funds that that would be recommended in the absence of bias.²⁶⁶ Even unbiased recommendations overweight factors (such as a fund's past return) that have little predictive power regarding future returns, and underweight factors that have significant predictive power (such as a fund's expense ratio).²⁶⁷ As a result, even unbiased mutual fund recommendations in personal finance magazines fail to give investors better returns.

Summary and analysis. Advertising works – investors buy funds that are advertised, and they especially buy heavily advertised funds. But advertising doesn't benefit investors; advertised funds do not outperform unadvertised funds going forward. In fact, rather than benefit investors, advertising likely works, at least in part, because it exploits and encourages a flaw in investors' decisionmaking – the belief that past returns predict future returns. Advertising, even with the many warnings required by SEC regulation, exacerbates investors' seeming ineluctable tendency to chase past returns. No doubt because of this tendency, mutual fund families especially advertise funds that have performed well in the past.

V. FIXING A DYSFUNCTIONAL MARKET

The academic literature paints a disturbing picture of how mutual fund investors actually behave. They erroneously focus on funds' past returns, while paying little attention to funds' risks and ongoing costs. What should be done in response to this behavior? The disclosure currently mandated by the SEC, the required warnings in mutual fund advertisements, and the advice of financial advisers are not sufficiently helping investors overcome their limitations. This section considers whether there are additional steps the SEC should take to help the mutual fund market function well.

²⁶⁵ Jonathan Reuter & Eric Zitzewitz, *Do Ads Influence Editors? Advertising and Bias in the Financial Media*, 121 Q. J. ECON. 197, 198 (2006).

²⁶⁶ *Id.* at 199.

²⁶⁷ *Id.* at 221-22.

A. Facilitating Access to Important Fund Information

The SEC ensures that important information about funds is available to investors, and encourages them to access the information. It requires mutual fund advertisements to advise investors “to consider the investment objectives, risks, and charges and expenses of the investment company carefully before investing.”²⁶⁸ This and other information is in the fund prospectus, which the SEC urges investors to read before investing.²⁶⁹ In addition, the SEC requires that critical information in the prospectus be presented in plain English and in standardized formats.²⁷⁰ The SEC’s website also explains how to read the prospectus, including the fee table and the risk/return bar charts.²⁷¹

Despite the SEC’s efforts, however, few investors refer to the prospectus. As a result, the SEC requirements largely create only the illusion of effective fund disclosure. For example, only 34% of the participants in the ICI survey said that they consulted a fund prospectus before investing.²⁷² This number may even understate the degree to which the prospectus is ignored by investors. Recall that the IC I survey was conducted through face-to-face interviews and surveyed only investors who had bought a fund outside of a work-related retirement plan. Out of embarrassment, such investors may have over-reported their use of the prospectus. In addition, because they own funds outside of an employer plan, those surveyed are likely more experienced and financially sophisticated than most fund investors, and thus may have been more likely to understand the importance of reading the prospectus.

Furthermore, even relatively sophisticated investors may be unable to understand the prospectus. As noted above, an experiment by Choi, Laibson, and Madrian asked Wharton MBA and Harvard undergraduate

²⁶⁸ 17 C.F.R. § 230.482(b)(1) (2008).

²⁶⁹ See, e.g., SEC, Look at More, *supra* note 221 (“[L]ook at more than the fund’s past performance when making your investment decisions. Read the fund’s prospectus and shareholder reports. . . .”); SEC, Invest Wisely, *supra* note 2 (“Before you invest, be sure to read a fund’s prospectus and shareholder reports. . . .”); *Id.* (“[Y]ou can – and should – request and read a fund’s prospectus before you invest. . . . While they may seem daunting at first, mutual fund prospectuses contain a treasure trove of valuable information.”).

²⁷⁰ These requirements are discussed *supra* pp. 23-27.

²⁷¹ Securities and Exchange Commission, Mutual Fund Prospectus: Tips for Reading One, <http://sec.gov/answers/mfprospectustips.htm> (last visited Feb. 18, 2008).

²⁷² ICI, INVESTOR PREFERENCES, *supra* note 28, at 4 fig.2.

students to allocate an investment among four S&P 500 index funds.²⁷³ To guide them, the students were given the funds' prospectuses, which include information on fund expenses.²⁷⁴ Despite this, over 95% of the participants failed to pick the best portfolio, which would have minimized expenses and thus maximized their return.²⁷⁵

The SEC also tries to educate fund investors through its website.²⁷⁶ But this effort may be mostly a futile gesture. At one time, the SEC reported 8,500 "hits" per month (about 100,000 hits per year) on its Mutual Fund Cost Calculator, "making it one of the most frequented portions of the SEC website."²⁷⁷ But the significance of that number should be viewed in context. A single investor can be responsible for multiple hits on a website. In addition, even if each hit came from a different investor, it would still constitute a tiny percentage of the 55 million U.S. households that own mutual funds.

Further evidence of the SEC's lack of influence in educating fund investors is that no investor survey has even mentioned the SEC as a source of information for investors. Indeed, even the SEC has acknowledged that its ability to educate investors is limited, and that investors must primarily learn about mutual funds from information provided by fund companies themselves.

B. Getting Investors To Pay Attention to Fund Expenses

The SEC encourages investors to pay attention to fund expenses and requires that the prospectus and annual report highlight expenses, putting them in a standardized tabular form for investors. This is salutary – investors are more likely to use clear, simplified information. For example, Choi, Laibson, and Madrian's experiment found that investors given both a one-page expense summary sheet with the prospectuses are more likely to pay attention to expenses and choose lower-expense funds than investors given only the prospectus.²⁷⁸ However, despite the SEC's effort,

²⁷³ Choi et al., *supra* note 189, at 7-8.

²⁷⁴ *Id.* at 3.

²⁷⁵ *Id.*

²⁷⁶ *See supra* pp. 29-32 for a discussion of these efforts.

²⁷⁷ Letter from Paul F. Roye, Div. of Inv. Mgmt., Sec. & Exch. Comm'n, to Thomas J. McCool, Dir., Fin. Inst. & Mkt. Issues, Gen. Gov't Div., U.S. Gen. Accounting Office (May 10, 2000), *available at* <http://www.gao.gov/archive/2000/gg00126.pdf> at 104.

²⁷⁸ Choi et al., *supra* note 189, at 4.

the academic finance literature has clearly found that investors still give little weight to fund expenses.

How might the SEC get investors to pay more attention to expenses? The information, including comparative data on expense ratios, is already readily available. For example, as noted above, the SEC's website offers a Mutual Fund Cost Calculator that allows investors to find, and compare the impact of, different funds' expense ratios.²⁷⁹ The problem is getting investors to access and act upon such information.

One possibility for getting investor attention is further disclosure reform. For example, as discussed above, the SEC's new proposal for a summary at the beginning of fund prospectuses in part attempts to "address[] concerns that investors do not understand that they pay ongoing costs every year when they invest in mutual funds."²⁸⁰ It does this by simplifying the wording of how it explains ongoing costs.²⁸¹ In addition, the proposal tries to increase the prominence of the disclosure of fund costs by moving the fee table to near the front of the prospectus summary.²⁸²

Cox and Payne have argued for a different type of disclosure. They have called for requiring each mutual fund to report how its expense ratio compares to that of comparable funds.²⁸³ They argue that this data is necessary to help investors overcome an evaluability problem. That is, knowing a fund's expense ratio is only helpful if the investor can also readily compare it to that of other funds.²⁸⁴

The mutual fund industry has criticized efforts to require comparable data on expense ratios. In particular, the industry has argued that it is

²⁷⁹ Securities and Exchange Commission, *The SEC Mutual Fund Cost Calculator: A Tool for Comparing Mutual Funds*, <http://www.sec.gov/investor/tools/mfcc/mfcc-intsec.htm> (last visited Feb. 18, 2008).

²⁸⁰ Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, 72 Fed. Reg. at 67,795.

²⁸¹ Recall that it changes an explanatory parenthetical from that follows the heading "Annual Fund Operating Expenses" from "expenses that are deducted from Fund assets" to "ongoing expenses that you pay each year as a percentage of the value of your investment." *Id.*

²⁸² *Id.* at 67,794.

²⁸³ James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 WASH. U. L.Q. 907, 936-37 (2005).

²⁸⁴ *Id.* at 933-36.

difficult to determine which funds are comparable to others.²⁸⁵ But the argument is a red herring. Investors choosing among mutual funds already must compare funds. The SEC or mutual funds themselves are unquestionably better able than are most investors to determine which funds are comparable. In addition, mutual funds already must make comparability determinations: the prospectus must compare a fund's historical returns to that of a relevant market index, necessarily implicating a comparability determination.²⁸⁶

Nonetheless, leading a horse to water is no assurance it will drink. Even if expense information were presented on a comparative basis and displayed more prominently, fund investors likely would still not give it sufficient weight given their infatuation (and that of an obliging industry) with past performance. If investors believe that a strong-performing fund will continue to outperform other funds, expenses become unimportant. For example, if investors believe that a particular fund, given its past performance, will outperform other funds even by only 2% annually, investors would buy that fund even if it has a 1% higher expense ratio than its peers. Dissuading fund investors of the persistence of returns may be a key to them paying more attention to fund expenses.²⁸⁷

C. Getting Investors To Pay Less Attention to Past Performance

The SEC already warns investors to discount the predictive value of past returns. For example, fund advertisements that report past returns (i.e. “performance advertisements”) must include the statement that “past performance does not guarantee future results [and] current performance may be lower or higher than the performance data quoted.”²⁸⁸ Also, the SEC’s website warns investors that “past performance does not necessarily predict future returns” and “past performance is not as important as you may think.”²⁸⁹

²⁸⁵ GAO, MUTUAL FUND FEES, *supra* note 62, at 81 (noting that most industry participants interviewed by the GAO raised such concerns).

²⁸⁶ Form N-1A, *supra* note 68, at Item 2.

²⁸⁷ GAO, MUTUAL FUND FEES, *supra* note 62, at 7 (“[C]ompetition in the mutual fund industry may not be strongly influencing fee levels because fund advisers generally compete on the basis of performance (measured by returns net of fees) or services provided rather than on the basis of the fees they charge.”).

²⁸⁸ 17 C.F.R. § 230.482(b)(3)(i) (2008).

²⁸⁹ SEC, Look at More, *supra* note 221.

Yet the SEC's warnings greatly understate the dangers of relying on past returns. Simply, there is little evidence that past returns are at all predictive of future returns.²⁹⁰ Thus warnings such as "past performance does not guarantee future results" are actually misleading. Investors need to understand not that a fund's past returns do not *guarantee* future results, but that past returns are not a very useful fund selection criterion at all. The SEC does not come close to conveying this.

In addition, the other SEC requirements undermine even its understated warnings about relying on past returns. For example, performance advertisements must also include a "toll-free or collect telephone number or a website where an investor may obtain performance data current to the most recent month-end."²⁹¹ Although this requirement seeks to ensure that investors do not buy a fund based on stale performance data,²⁹² it also sends the implicit message that the fund's most recent performance is important in choosing a fund. Thus, the SEC is throwing fuel on the returns-chasing fire.

The problem of investors chasing past returns is further exacerbated by the way mutual funds, fund advisers and financial publications pander to this tendency. Fund advisers and fund performance rankings encourage investors, both explicitly and implicitly, to focus on a fund's past performance. Indeed, fund investors in Capon, Fitzsimons, and Prince's survey, said that published performance rankings are their most important information source²⁹³ and that a fund's "Investment Performance Track Record" is their most important selection criterion.²⁹⁴

D. Paying Attention to the Academic Literature

The SEC's current disclosure-based regime is unlikely to result in fund investors imposing a strong market discipline on fund management companies. Simply stated, the agency's implicit and explicit assumptions

²⁹⁰ See *supra* pp. 47-48.

²⁹¹ 17 C.F.R. § 230.482(b)(3)(i) (2008).

²⁹² The SEC explained that it was adopting this requirement so that "investors who are provided advertisements highlighting a fund's performance [will] have ready access to performance data that is current to the most recent month-end and will not be forced to rely on performance data that may be more than three months old at the time of use by the investor." Amendments to Investment Company Advertising Rules, 68 Fed. Reg. at 57,763.

²⁹³ Capon et al., *supra* note 138, at 66 tbl.1.

²⁹⁴ *Id.*

about fund investors are unrealistic, given the realities of fund investor behavior documented by the extensive academic literature. To date, the SEC essentially ignores this literature in formulating its regulation of the industry.

The extent to which the SEC disregards this academic research is evident from the SEC's rulemaking releases, which contain the agency's explanations and rationales for its rule proposals. In these releases, the SEC often cites to outside sources. We identified five times that the SEC has recently amended rules regarding information that mutual funds must disclose to current or potential investors. Table 1 identifies the sources relied upon by the SEC in its releases accompanying these amendments, and the number of times the SEC cited to each source.

TABLE 1: SEC CITES TO OUTSIDE SOURCES

TOPIC	Comment letters	ICI comments	News stories	Non-academic research	ICI research	Academic research
Prospectus disclosure (1998) ²⁹⁵	78	3	19	1	7	0
Fund profile disclosure (1998) ²⁹⁶	256	1	2	0	4	0
Advertising rules (2003) ²⁹⁷	29	0	2	0	1	0
Shareholder reports disclosure (2004) ²⁹⁸	65	1	5	0	4	0
Portfolio manager disclosure (2004) ²⁹⁹	34	3	0	0	0	1
TOTAL	462	8	28	1	16	1

²⁹⁵ Registration Form Used by Open-End Management Investment Companies, 63 Fed. Reg. 13,916.

²⁹⁶ New Disclosure Option for Open-End Management Investment Companies, 63 Fed. Reg. 13,968.

²⁹⁷ Amendments to Investment Company Advertising Rules, 68 Fed. Reg. 57,760.

²⁹⁸ Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, 69 Fed. Reg. 11,244.

²⁹⁹ Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, 69 Fed. Reg. 52,788 (Aug. 27, 2004) (to be codified at 17 C.F.R. pt. 239, 249, 270, 274).

As shown in Table 1, the SEC's efforts to reform fund disclosure have not relied on independent empirical data indicating whether investors can understand, and will use, the information that the SEC requires mutual funds to present to them. For example, in 1998, the SEC adopted amendments to the form used by mutual funds to register and offer their shares.³⁰⁰ The amendments were "intended to improve fund prospectus disclosure and to promote more effective communication of information about funds to investors."³⁰¹ In its rulemaking, however, the SEC cited no academic studies of how investors actually make their fund choices.

Instead of turning to the academic literature, the SEC has relied on the fund industry to formulate its understanding of investor informational needs. For example, in its 1998 prospectus disclosure rulemaking, the SEC cited to ICI research reports seven times, and to ICI comment letters three times, to support SEC conclusions about the nature of the mutual fund market and the information needs of fund investors.³⁰² The SEC noted, for example, that an ICI survey found that investors responded "very positively" to profile summaries of fund information³⁰³ The only non-ICI study cited by the SEC was a survey by the American Association of Retired Persons that found that "the vast majority of American bank customers who hold shares of mutual funds are unaware of the risks and fees involved in the sale of mutual funds."³⁰⁴

As noted in Table 1, the only cite to academic research was in the rule intended to improve mutual funds' disclosure regarding their portfolio managers. Even that cite, however, was not to research on investor behavior. Instead, it stated the basic proposition that "[m]anagement investment companies typically issue shares representing an undivided

³⁰⁰ Registration Form Used by Open-End Management Investment Companies, 63 Fed. Reg. 13,916.

³⁰¹ Registration Form Used by Open-End Management Investment Companies, 63 Fed. Reg. at 13,916.

³⁰² Registration Form Used by Open-End Management Investment Companies, 63 Fed. Reg. 13,916.

³⁰³ *Id.* at 13,918 n.17.

³⁰³ New Disclosure Option for Open-End Management Investment Companies, 63 Fed. Reg. at 13,969.

³⁰⁴ Registration Form Used by Open-End Management Investment Companies, 63 Fed. Reg. at 13,925 n.82.

proportionate interest in a changing pool of securities, and include open-end and closed-end companies.”³⁰⁵

In fact, it appears the SEC, until very recently, had referred to the academic literature only once in connection with the informational needs of fund investors. In an educational document on its website, “Invest Wisely: An Introduction to Mutual Funds,” the SEC states:

Past performance is not a reliable indicator of future performance. So don't be dazzled by last year's high returns. ... A fund's past performance is not as important as you might think. Advertisements, rankings, and ratings often emphasize how well a fund has performed in the past. *But studies show that the future is often different.* This year's “number one” fund can easily become next year's below average fund.³⁰⁶ (italics added)

In its November 2007 proposal regarding the summary section of the full prospectus and the creation of the Summary Prospectus, the SEC again cited the academic literature. In that rulemaking proposal, the SEC cites to one academic study as support for the general proposition that there are “continuing concerns about investor understanding of mutual fund costs.”³⁰⁷

Although SEC references to the academic literature are rare, the SEC has sometimes cited to the popular media for anecdotal evidence of the difficulties fund investors have in understanding fund disclosure. In its rulemaking on prospectus disclosure,³⁰⁸ its adoption of the fund profile³⁰⁹ and its changes to the rules on advertising content,³¹⁰ the SEC liberally cites to news articles suggesting fund investors' limitations.

³⁰⁵ Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, 69 Fed. Reg. at 52,788 n.7.

³⁰⁶ SEC, Invest Wisely, *supra* note 2.

³⁰⁷ Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, 72 Fed. Reg. 67,794 & n.45.

³⁰⁸ Registration Form Used by Open-End Management Investment Companies, 63 Fed. Reg. 13,916.

³⁰⁹ New Disclosure Option for Open-End Management Investment Companies, 63 Fed. Reg. at 13,969.

³¹⁰ Amendments to Investment Company Advertising Rules, 68 Fed. Reg. 57,760.

In the SEC's adopting release on fund prospectus disclosure, for example, there are at least 19 cites to news articles, mostly journalistic critiques of the opacity of fund disclosure.³¹¹

In short, the SEC's understanding of the mutual fund investor is an understanding largely drawn from the mutual fund industry, not from independent research. Interestingly, the need to pay attention to academic research is not lost on everyone in the agency. In a recent speech, Brian Cartwright (the General Counsel of the SEC) pointed out that "[g]iven the practical applications of theoretical finance, it's not surprising that today hedge fund managers regularly turn up at academic conferences and eagerly scour the academic literature for the next big thing. Regulators should too. If the investment choice most important for retail investors these days is not which stock or bond to buy, but which fund (or other intermediary) to choose, we need to find ways to apply the insights recent finance theory has given us in the service of retail investors."³¹² This would be a salutary first step.

CONCLUSION

Retirement and saving for retirement are relatively recent phenomena. Seven decades ago our national retirement program was entrusted to a federal bureaucracy. Two decades later, our private retirement savings moved to company and government pension plans, administered by professional money managers. Today as Social Security becomes less certain and defined-benefit pension plans give way to defined-contribution plans, our retirement savings has moved to mutual funds. In the process, fund investors have found themselves responsible for making the essential investment choices concerning our own retirement savings.

Are mutual fund investors up to this heady new role? The mutual fund industry takes the position that fund investors are mostly knowledgeable and capable, though they could always use even more simplified disclosure. The SEC, the regulator on behalf of fund investors, has expressed some concern about investors' capabilities, but has sought to address these concerns through required warnings and simplified

³¹¹ See, e.g., Registration Form Used by Open-End Management Investment Companies, 63 Fed. Reg. 13,916.

³¹² Brian G. Cartwright, Gen. Counsel, Sec. & Exch. Comm'n, Remarks at the University of Pennsylvania Law School Institute for Law and Economics: The Future of Securities Regulation (Oct. 24, 2007), (transcript available at <http://www.sec.gov/news/speech/2007/spch102407bgc.htm>).

disclosure, with a casual nod to more investor education. In contrast to the mutual fund industry and the SEC, an extensive academic literature finds that mutual fund investors are largely ignorant of even the basics of their mutual funds, and disregard fund risks and costs to chase past returns.

The fund industry, while painting a favorable portrait of fund investors, benefits from investor ignorance. The industry earns fees based on assets under management, and investors who pay little attention to fund costs create little pressure to lower these costs. In addition, investors' tendency to chase past returns makes marketing funds a simple matter of promoting past winners to attract the growing stream of retirement savings flowing to the industry. So long as investors pay little attention to fund costs, which has largely been the case, the industry has an unassailable and highly profitable business model.

Furthermore, the industry's favorable portrait of fund investors undercuts the need for regulatory protection. Thus, by advancing the notion of a functional investor-driven market, the ICI discourages intrusive regulation of the industry. The ICI has masterfully played the role of supporting disclosure-simplification reforms in the name of investor empowerment, while resisting providing clear comparative information on the grounds that investors can glean such information on their own.

The SEC has undertaken only marginal reforms primarily focused on streamlined disclosure and formulaic warnings. Relying predominantly on the industry for information about investor needs, the SEC has largely accepted the story of a functional demand-side market. While the SEC's reforms play around the edges of addressing investors' inability to fend for themselves, the agency seems in denial about the extent of the market's dysfunctionality. The SEC's almost complete disregard of academic studies of fund investor behavior ensures that investors' limitations will continue to greatly underestimated, and that any further reforms will miss their mark.

As mutual fund investors, our financial future has been placed in our hands. And, as Pogo observed and the SEC has yet to fully recognize, "we have met the enemy and he is us."